ECONOMIC ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS

for

RESPA Proposed Rule to Simplify and Improve the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers

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U.S. Department of Housing and Urban Development
Office of Policy Development and Research

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EXECUTIVE SUMMARY

I. Introduction and Need for Proposed Rule

The Department of Housing and Urban Development issued a proposed rule under the Real Estate Settlement Procedures Act (RESPA) to simplify and improve the process of obtaining home mortgages and to reduce settlement costs for consumers. This Economic Analysis and Initial Regulatory Flexibility Analysis examine the economic effects of that rule.[1] The proposed rule is expected to improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction. A number of benefits, costs, efficiencies, transfers, and market impacts are identified in this Economic Analysis.

A. Problems With the Current System

As discussed in this Economic Analysis, today's settlement process is plagued with problems that limit both consumer shopping and competition among settlement service providers, with the result that consumers pay high prices for originating and closing a mortgage. The current Good Faith Estimate (GFE) format contains a long list of individual charges that can be overwhelming, often confuses consumers, and seems to provide little useful information for consumer shopping. By requiring a long listing on the GFE of each estimated settlement charge, the current disclosure fails to highlight the major costs and may lead to a proliferation of charges. All too often, consumers are surprised at closing when the expenses on their HUD-1 are greater than those quoted on the GFE given to them at the beginning of the mortgage process.

Under current RESPA rules, there is some confusion concerning the role of the mortgage broker and how the broker is compensated. Originators frequently do not fully inform consumers of the trade-off between accepting a loan with a higher interest rate and paying lower cash at settlement. In addition, there is no assurance that consumers receive the full benefit of any payments (i.e., yield spread premiums) from wholesale lenders for their accepting a loan with a higher interest rate.

Finally, today's RESPA rules hold back efficiency and competition by acting as a barrier to the packaging of settlement services. While today's mortgage market is characterized by increased efficiencies and lower prices due to technological advances and other innovations, that is not the case in the settlement area where aggressive competition among settlement service providers is impeded by current regulatory barriers.

[1] The term "Economic Analysis" will be used in the remainder of this Executive Summary.

B. Dual Approach

The proposed RESPA rule offers a dual approach to these settlement market problems: (1) a new, simplified GFE combined with tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions; and (2) a guaranteed cost approach based on packaging of settlement services. Consumers and originators can use either approach, which has the advantage of allowing the market determine the best approach under a given set of circumstances. While there are reasons to expect originators to move toward the packaging approach, it is difficult to estimate the share of the market that will ultimately fall under packaging, as well as the timing of the move toward packaging.

Because the proposed rule calls for significant changes in the process of originating a mortgage, this Economic Analysis identifies a wide range of benefits, costs, efficiencies, transfers, and market impacts. The effects on consumers from improved borrower shopping could be substantial if the proposed rule is finalized. Ensuring that yield spread premiums are properly credited to borrowers in brokered transactions could cause significant transfers to borrowers. Similarly, increased competition associated with packaging could result in large reductions in settlement service costs, and associated income transfers from service providers who are earning "economic rents" in today's system to borrowers, who would most likely be the ultimate beneficiaries of more competition among settlement service providers. Entities that would suffer revenue losses under the proposed rule are usually those who overcharge uninformed borrowers, or are high cost producers, or are benefiting from the current system's restrictions on competition.

While the benefits, costs, transfers, efficiencies and market impacts of the two approaches are basically similar, in terms of encouraging improved consumer shopping and lower settlement service costs, each approach has its own specific effects. They are summarized next.

II. New Good Faith Estimate Approach

A. GFE Approach -- Main Components

The new GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement in clarity over today's GFE, which contains a long list of individual charges that encourages fee proliferation and junk fees, and can often overwhelm and confuse consumers. The new GFE also makes cost estimates more certain, by requiring that loan originators adhere to amounts reported on the GFE for major cost categories (such as origination fees), and on additional cost categories give estimates subject to a 10% upper limit, or tolerance. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement.

The new GFE will better inform consumers about their financing choices by requiring that lenders explain the different interest rate and closing cost options available to consumers.

For example, consumers will be more likely to fully understand the trade-offs between reducing their closing costs and increasing the interest rate on the mortgage.

The proposed rule ensures that, in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with an above-par interest rate; that is, yield spread premiums are credited to the borrower. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs.

B. GFE Approach -- Impacts

There are two general impacts, one concerning borrowers shopping among originators and another concerning originators shopping for third party settlement services. First, the simplicity and certainty offered by the new GFE should improve comparison shopping for mortgage loans, reduce interest rates and settlement prices for borrowers, and eliminate surprises at settlement. There will be less of the sub-optimal consumer shopping that often characterizes today's mortgage market. Originators will be less able to take advantage of uninformed shoppers. The new GFE format will improve comparison shopping, which will result in better mortgage products, lower interest rates, and lower settlement costs for borrowers.

Second, the imposition of tolerances on fees will encourage originators to seek discounts and cut settlement service prices. The proposed rule clarifies that loan originators can make arrangements with their third party settlement service providers (appraisers, settlement service agents, etc.) to lower prices for their customers (i.e., borrowers), provided these prices or any fees on the GFE are not "marked up" or "up charged."

The various estimates of benefits, costs, transfers, and efficiency gains provided in this Economic Analysis are based on specific sets of assumptions. They are useful because they provide a sense of the overall magnitude of the annual benefits of the proposed new GFE approach to consumers. Some of the estimated effects of the new GFE approach are as follows:

- Under one set of assumptions, the Economic Analysis estimates that $7.5 billion of the $15 billion in total yield premium payments (YSPs) is not passed through to borrowers to reduce closing costs. If the proposed rule results in half of this $7.5 billion being recaptured by borrowers, then the annual impact would be $3.75 billion. While this figure will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on the return of YSPs to borrowers as reduced closing costs.

- Direct origination fees are estimated to be $15 billion (which when added to the $15 billion in YSPs results in total originator compensation of $30 billion). In addition to the $3.75 billion in YSPs recaptured by borrowers, it is also assumed that improved shopping enables borrowers to capture five percent (or $0.75 billion) of originators' direct origination fees of $15 billion.

- The Economic Analysis estimates that $18 billion in third-party fees would be subject to increased price pressure as a result of the imposition of tolerances and expanded shopping by originators. While it is difficult to estimate how much tolerances and expanded originator shopping will reduce the $18 billion, this figure provides a base on which this effect will be felt. The estimates reported below assume that third-party fees would fall by 10 percent, or $1.8 billion.

- It was estimated that borrowers would save $6.3 billion in annual settlement charges. This $6.3 billion represents transfers to borrowers from higher priced producers, with $4.5 billion coming from originators[2] and $1.8 billion from third party settlement service providers.

- In addition to the transfers, there are several efficiencies associated with the new GFE. Borrowers realize efficiencies of $826 million in savings in time spent shopping for loans and third party services. Loan originators save in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. The originator and third party efficiencies are estimated to be approximately $1.6 billion that could be passed through to borrowers through competition.

    - There are other potential efficiencies that are not included in the above estimates. For instance, one impediment to low-income and minority homeownership is an uncertainty and fear of the mortgage lending process and predatory practices. Over time, the new GFE approach (as well as packaging) should reduce this uncertainty and increase homeownership.

- There are some direct costs to originators from complying with the new GFE, although they don't appear to be large. While the new GFE format requires less itemization than today's GFE, the HUD-1, with its detailed itemization, remains essentially the same. Originators and closing agents will have to expend some minimal effort in explaining to consumers the cross walk between the new streamlined GFE and the more detailed HUD-1. If it takes an additional 10 extra minutes to handle the forms, costs to originators could rise by about $225 million.

- The imposition of zero and 10 percent tolerances on fees will require lenders to make arrangements with third party settlement service providers, in order for the originator to come up with estimates that can be delivered within the tolerances. Estimated annual costs could be $25-$50 million.

C. GFE Approach – Small Business Impacts and Alternatives Considered

[2] The $3.75 billion in YSPs recaptured by borrowers plus the $0.75 billion in reduced direct origination fees give $4.5 billion in transfers to borrowers from originators.

It is estimated that $3.5 billion of the $6.3 billion in transfers to borrowers comes from small originators ($2.2 billion) such as small brokers and small settlement service providers ($1.3 billion).

Under these new rules, brokers must report the total origination fees they receive on the GFE and the HUD-1 -- rather than their origination fees net of any yield spread premium they receive. Thus, the new GFE clarifies what brokers are receiving for loan origination and in broker-transactions ensures that yield spread premiums will be passed on to the borrower. As explained in the proposed rule, it is not practical to implement such a system for lenders, which means that lenders can continue to report their origination fees on a net basis if they so choose.[3] However, HUD has designed the new GFE form so that it reduces any anti-competitive effects between brokers and lenders. For purposes of comparing lender and broker offers, the new GFE focuses the borrower's attention on the right number, which is the subtotal after reducing total origination fees by any lender payment to the borrower (i.e. yield spread premium). This should reduce any anti-competitive impacts of the proposed rule on brokers, who are mainly small businesses.

The Economic Analysis concludes that brokers as a group will remain highly competitive actors in the mortgage market. There is no evidence to suggest that there would be any major anti-competitive impact on the broker industry from this proposed rule. Rather, the main impact on brokers (both small and large) would be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.

Increased competition will also be applied in the market for third-party settlement service providers. Thus, those small (as well as large) third party settlement service providers that are currently charging high prices would experience a reduction in their revenues.

Alternatives Considered. In developing the proposed rule, the Department considered several alternative policies that relate to the rule's impact on small businesses. One alternative considered was to place the interest rate dependent variable at the bottom of the new GFE form after all of the other settlement costs, which would have highlighted how the yield spread premium can be used to partially or fully cover total settlement costs. Rather, the Department chose to place the interest rate dependent variable directly after the origination charge, coming up with a net origination charge, which is highlighted in the new GFE. This was done to minimize the chance of an unsophisticated borrower missing the fact that the yield spread premium payment to the borrower was offsetting the broker's origination charge, and thus thinking that brokered loans were more costly than non-brokered loans.

The division of the origination charge into broker and lender portions is now off the front page of the new GFE form. The Department considered placing it on the front page but rejected that idea and, instead, placed it on the second page. This reduces the prominence of a difference that would appear in otherwise identical loans when the only difference is in the type of originator. Loans with identical origination charges from brokers will now have the same number presented in the origination charge on the front of the form, regardless of how the fee is

[3] This also includes those brokers who have wholesale lines of credit.

broken down between the broker and the lender. The removal of the breakout from the front page makes it less likely that shoppers will be confused.

The Department considered having zero tolerance on both the lender and broker components of the origination charge instead of zero tolerance on the total. Zero tolerance on the components would have given brokers less flexibility in switching lenders, even if the total of the lender and broker fees would remain the same. The method selected makes it easier for brokers to switch lenders, so long as the total origination charge does not rise.

In Section I of the new GFE, the Department considered having different statements of the services of the originator for brokers and lenders. The purpose of this section of the new GFE is to alert borrowers to shop in order to protect their interests. If this were required only of brokers, then brokers would be telling their customers to shop, look elsewhere, while lenders would not have to tell their customers the same thing. That would not be equal treatment and would place brokers at a disadvantage. Also, some borrowers might think that an originator who fits the broad definition of a broker is their "shopper" and that they do not have to shop to protect their interests. They are misinformed and need this disclosure in order to be aware of how to protect themselves. Thus the Department adopted the idea that every originator would have to deliver the same message. Every borrower gets the same warning and no originator is at a disadvantage in delivering the message.

II. Guaranteed Cost or Packaging Approach

A. Packaging -- Main Components

Under this approach, a packager would offer a lump-sum price for settlement costs and would be held to that figure from the time the package is agreed to through settlement. The "Guaranteed Mortgage Package Agreement", which is a contract between the originator and the borrower that replaces the GFE, would include all origination and other settlement services needed to close a mortgage.[4] The package would also include a guaranteed interest rate subject to change (for those borrowers that do not lock-in) only from a change in an observable and verifiable index.

The proposed rule offers a safe harbor from Section 8 for those entities providing or participating in a "Guaranteed Mortgage Package Agreement" (GMPA). The safe harbor applies an exemption from Section 8 to all consumer payments for the GMPA, as well as any payments between entities participating in the GMPA.[5] The Section 8 safe harbor will allow protection

[4] Including all application, origination and underwriting services, the appraisal, pest inspection, flood review, title services and insurance, and any other lender required services except hazard insurance, per diem interest, and escrow deposits.

[5] Section 8 would continue to apply to any payments for the referral of business, kickbacks, splits of fees and unearned fees between the packager and any of the entities participating in the package, on the one hand, and entities outside of the GMPA, on the other hand. The safe harbor exemption is available only where the origination does not result in a high cost loan as that term is defined in the Homeownership Equity Protection Act.

for entities within the package from charges of illegal referral fees, kickbacks, and unearned fees. This will free up packagers to pursue lower prices for third party services in their package without concern that the technique used could be a Section 8 violation. Competition is substituted for regulation.

A. Packaging -- Impacts

First, guaranteed packaging will improve and increase borrower shopping for mortgages. Basically, guaranteed packaging reduces the loan offer to a settlement package price, an interest rate, an APR, and a PMI premium rate. The package price and the PMI premium have zero tolerance, and the interest rate is guaranteed if locked (otherwise the rate varies with a market index). In addition, the offer is free and, if agreed upon by the borrower, the offer becomes a contract that is enforceable. These are all advantages over today's process of shopping for mortgages. Economic efficiencies result from easier and less time consuming shopping under packaging. Borrowers are better informed, shop better, and reach better deals.

Second, the guaranteed packing approach would remove regulatory barriers that are today preventing market competition from reducing settlement prices. Under current law, a providers' efforts to enter into volume arrangements with settlement service firms may be regarded as illegal and restrictions against mark-ups of third party costs may impede the packaging of services. Under the proposed rule, packagers will be able to enter into cost-reducing, volume-discount arrangements, and competition among packagers will pass these lower costs through to borrowers at mortgage settlement.

While these benefits of packaging are basically similar to the benefits of the new Good Faith Estimate approach discussed above, it is anticipated that packaging will improve shopping and lower settlement costs to an even greater extent than the GFE approach. Some of the main effects of packaging are as follows:

- In addition to lower prices due to better borrower shopping among originators, packaging will also result in lower prices paid for settlement services, as packagers aggressively seek discounts in third-party service prices. A better shopper (the packager) is substituted for the borrower as the searcher for third party settlement services. Efficiencies also could result because originators may deal with one packager, rather than a whole array of third party providers and the packager, who specializes in this activity, may be more efficient than the originator.

- It is estimated that transfers to borrowers will total $10.3 billion, or $4.0 billion more than the potential transfers of $6.3 billion under the new GFE approach. Originators contribute $6.7 billion of this and third party settlement service providers, $3.6 billion. These transfers to consumers come from further reductions in overcharges that competition passes on to borrowers.[6]

[6] Under the set of assumptions behind these estimates, the final transfers to the borrower would depend on how the market settles down between the two methods of loan origination – the new GFE approach and packaging. If it is half and half, transfers to borrowers are slightly over $8 billion.

- In addition to the above transfers, the Economic Analysis estimates that borrowers realize efficiencies of $1.65 billion in time saved and originators and third parties realize $3.4 billion in efficiencies that could be passed through to borrowers through competition (see list of efficiencies for the new GFE approach in II.B above).

- The simplification and other advantages of the new GMPA form will lead to lower costs than under the new GFE form and likely no more costs than today's GFE. One area of uncertainty about packaging concerns the index that is used to ensure that changes in the interest (note) rate reflect changes in the market. Until the exact mechanism is selected, it is difficult to determine the effect of the index issue on packaging.

C. Packaging – Small Business Impacts and Alternatives Considered

Uncertainty has been expressed about the market impacts of packaging, including the potential impacts on small businesses. The main findings regarding market effects and small businesses under packaging are as follows:

- Packaging could take several forms but it is difficult to predict the outcome. For example, originators could develop their own packages or specialized firms could develop packages, or components of packages, which they would then sell them to originators.

- The nature of locally-provided, third party services (mainly small businesses such as appraisal, survey, pest inspection, closing agents) could remain the same under packaging. The main change is that packagers will be the new purchasers of these services, and third party service prices will be lower.

- It is estimated that small businesses (i.e., small originators and small service providers) would account for $5.9 billion of the $10.3 billion in transfers to consumers noted above -- $3.4 billion of this would come from small originators and $2.5 billion would come from small settlement service providers. As in the case with the new GFE approach, firms suffering losers under packaging are originators and third party providers who are currently charging high prices for their services.

- Still, there is no strong reason to expect that locally-based small businesses could not continue providing third party settlement services under packaging, albeit at possibly lower prices and revenues, as noted above. Services that are local in nature (such as appraisals) will continue to be demanded under the packaging approach. Services that are national in nature and characterized by economies of scale (such as credit reporting) are already being conducted by larger firms on a national scale.

- There has also been a concern that small lenders would be placed at a disadvantage under packaging because of the "bulk" buying power of large lenders. While this may be the case, it does not have to be. First, there is no evidence of this effect today where large lenders can purchase services such as appraisals on a "bulk" basis. Second, if specialized packaging firms develop, it seems reasonable to expect them to offer their packages to small lenders as well as large lenders. It is difficult to reach firm conclusions about the magnitude of the impact on small lenders.

- Brokers, most of whom are small businesses, could pursue a number of avenues under packaging. They could develop their own package, purchase one from specialized firms, or use the package offered by the wholesale lender they are dealing with. Under packaging, brokers will continue their main function of reaching the consumer, just as they do today. This customer outreach function is not going to go away with packaging and the underlying competitive strengths of brokers are also not going to disappear with packaging.

Alternatives Considered. There were alternative policies that would affect small businesses differently. One alternative would have left lenders as the only packagers. This idea was rejected in favor of allowing anyone to package so long as the package contains a loan. Thus, lenders, real estate brokers, appraisers, settlement agents, or literally anyone else may form the package and be eligible for the safe harbor for which it qualifies. No one, large or small, is favored by any artificial restriction. Furthermore, sub-packages may be formed and sold to full-fledged packagers. This is permissible since the sub-packager is within the package. This further affords smaller firms to offer their services and benefit from a packaging environment.

Under packaging, there is no separate treatment of yield spread premiums or discounts and no special rules for brokers. Competition is thought to be an adequate substitute for regulation in the packaging option. The simplicity of getting so many otherwise itemized costs in one figure that would be subject to all the borrower's shopping and competitive efforts is thought to justify lumping the yield spread premium or discount into the guaranteed price. Thus, all originators (brokers or otherwise) present their loans the same way and all the market's competitive forces are applied to everything in the package regardless of the type of originator.

IV. Organization of the Economic Analysis

Chapter 1 explains the purposes of the Economic Analysis and the Initial Regulatory Flexibility Analysis. Chapter 2 provides background material – it gives a brief overview of the mortgage market, highlights the role of major industry players such as brokers, and presents information on yield spread premiums. The benefits, costs, transfers, efficiencies, and market impacts of the proposed rule are discussed in Chapters 3 and 4. Chapter 3 discusses the new Good Faith Estimate, including the provisions of the rule that address the problem of lender payments to brokers. Chapter 4 discusses packaging, or the guaranteed cost approach. Chapter 5 provides a summary of the main impacts, including those on small businesses.

CHAPTER 1

INTRODUCTION

The Department of Housing and Urban Development issued a proposed rule under the Real Estate Settlement Procedures Act (RESPA) to simplify and improve the process of obtaining home mortgages and to reduce settlement costs for consumers. This Economic Analysis and Initial Regulatory Flexibility Analysis examine the economic effects of that rule.[7] As this Economic Analysis demonstrates, the proposed rule is expected to improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction. A number of benefits, costs, transfers, efficiencies, and market impacts are identified in this Economic Analysis.

Section I briefly summarizes the proposed rule and Section II explains the need for the rule. Section III discusses the objectives of an Economic Analysis and discusses the need for a small business analysis, since many of the provisions of the proposed rule cover small businesses such as brokers. Section IV discusses the scope of the analyses covered in this Economic Analysis. Section V describes the remaining chapters in this Economic Analysis.

I. Main Components of the Proposed Rule

The substance of the proposed rule can be divided into three broad areas. To simplify and improve the mortgage loan process, the proposed rule first addresses the problem of lender payments to mortgage brokers by fundamentally changing the way in which these payments in brokered mortgage transactions are recorded and reported to borrowers. The proposed rule ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, so-called yield spread premiums will directly offset borrower closing costs. Second, the proposed rule significantly improved HUD's Good Faith Estimate (GFE) settlement cost disclosure to make the GFE simpler, firmer, and more usable to facilitate shopping for mortgages and to prevent unexpected charges to consumers at settlement. Finally, the proposed rule removes regulatory barriers to allow guaranteed packages of settlement services and mortgages to be made available to consumers, to make shopping by consumers for mortgages even easier, and to further reduce settlement costs.

[7] The term "Economic Analysis" will often be used to refer to both the Initial Regulatory Flexibility Analysis as well as the Economic Analysis.

II. Need for Proposed Rule[8]

Under current rules, there is some confusion concerning the role of the mortgage broker, and how the broker is compensated. There is no assurance that payments from wholesale lenders to brokers are applied to help offset the consumers' settlement costs. The proposed rule would address this problem by requiring mortgage brokers to tell consumers what they charge and how lender payments can help reduce settlement costs; and by ensuring that in brokered loans, consumers receive the full benefit of any payments (i.e., yield spread premiums) from wholesale lenders for accepting a loan with a higher rate.

The current GFE format contains a long list of individual charges that can be overwhelming, often confuses consumers, and seems to provide little useful information for consumer shopping. By requiring a long listing on the GFE of each estimated settlement charge, the current disclosure fails to highlight the major costs and seems to lead only to a proliferation of charges. So that consumers can understand and compare mortgage costs across different originators, the proposed GFE form would consolidate costs into a few major cost categories, thus eliminating the listing of individual fees. The proposed rule would also make cost estimates more certain, by requiring that loan originators adhere to amounts reported on the GFE for major cost categories, and on additional cost categories give estimates subject to a 10% upper limit, or tolerance. The simplicity and certainty offered by the new GFE should improve consumer shopping for mortgage loans.

The proposed rule would remove regulatory barriers to allow settlement service providers to offer packages of settlement services, which current RESPA regulations impede. Packagers (lenders, brokers, other settlement service providers, or any other entities) would offer consumers at no cost, a guaranteed price for settlement services, an interest rate guarantee, and a Guaranteed Mortgage Package Agreement in lieu of a GFE. These packagers would thereby qualify for a safe harbor under RESPA. Packaging would promote competition and reduce settlement service charges, as well as further facilitating shopping by consumers.

III. Economic Analysis and Initial Regulatory Flexibility Analysis

A. Requirement for an Economic Analysis

Under Executive Order 12866 (October 4, 1993), federal agencies are required to determine whether a regulatory action is economically "significant" and therefore subject to review by the Office of Management and Budget (OMB). The executive order defines an economically-significant regulatory action as one that is likely to result in a rule that may have an annual effect on the economy of $100 million or more; it is estimated that this proposed rule meets this threshold and thus qualifies as economically significant.

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[8] Section I of Chapters 3 and 4 provide a more detailed discussion of problems with the current system. The problems addressed by the proposed RESPA rule were also discussed in the joint HUD-Fed report, *Joint Report to the Congress Concerning Reform of the Truth and Lending Act and the Real Estate Settlement Procedures Act*, July 1998.

The primary objectives of the executive order are to encourage the cost-effectiveness of proposed regulatory actions and to make the regulatory process transparent to the public. Thus, an economic analysis of a regulatory impact must provide adequate information indicating the need for and consequences of the proposed action; a demonstration that the potential benefits to society of the rule justify the potential costs; a discussion of alternative actions; and evidence that agency decisions are based on the best reasonably obtainable information. This document is provided to meet the requirements of the executive order.

B. Small Business Analysis

B.1 Requirements

The Regulatory Flexibility Act (5 U.S. 603) requires an Initial Regulatory Flexibility Analysis examining the effects on small businesses. Each Initial Regulatory Flexibility Analysis is required to contain:

1. a description of the reasons why action by the agency is being considered;
2. a succinct statement of the objectives of, and legal basis for, the proposed rule;
3. a description of and, where possible, an estimate of the number of small entities to which the proposed rule will apply;
4. a description of the projected reporting, record keeping, and other compliance requirements, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record; and,
5. an identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap or conflict with the proposed rule.

Each Initial Regulatory Flexibility Analysis shall also contain a description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities. Consistent with the stated objectives of applicable statutes, the analysis shall discuss significant alternatives such as:

- the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities;
- the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities;
- the use of performance rather than design standards; and
- an exemption from coverage of the rule, or any part thereof, for such small entities.

This document is provided to meet the requirements of the Initial Regulatory Flexibility Analysis (IRFA). As explained in Chapters 3 and 4, the proposed rule includes provisions that apply to small businesses such as brokers, small lenders, and small settlement service providers. Chapter 3 (with respect to the new GFE approach) and Chapter 4 (with respect to packaging) discuss: the reasons for, and objectives of the proposed rule (IRFA requirements 1 and 2 above); the estimated impacts on small businesses (IRFA requirement 3), and the compliance and other costs associated with the new GFE and GMPA forms (IRFA requirement 4). Alternative policies with potential impacts on small businesses are discussed in Section III.C and Appendix A of Chapters 3 and in Section IV.C of Chapter 4. The impacts on small businesses are summarized in the Executive Summary, Sections I.B of Chapters 3 and 4 and Chapter 5.[9]

With respect to 5, the following applies:

- The Truth in Lending Act, 15 USC Section 1601-1655(b) (TILA) discloses the cost of credit. Under TILA, the consumer must be provided information on the amount financed, the number, amount, and due dates of payments, the total number of payments, and the finance charge expressed as an Annual Percentage Rate. Certain TILA disclosures are to be given at the same time the good faith estimate is given under RESPA.

- The implementing regulations under the Equal Credit Opportunity Act, 15 USC 1691, (ECOA) specify that the borrower shall be informed of the right to request a copy of the appraisal at any time during the application process, but no later than when the creditor provides notice of action.

- The Fair Credit Reporting Act, 15 USC 1681, (FCRA) requires that the consumer must be notified of the right to request his credit report only when adverse action has been taken (i.e. credit has been denied).

HUD's proposal requires disclosure of the Annual Percentage Rate on the Good Faith Estimate and the Guaranteed Mortgage Package Agreement. As a condition of the safe harbor, the proposed rule would require that appraisals and credit reports be made available to borrowers for guaranteed mortgage packages. These requirements only apply at the option of an entity, where it chooses to gain the benefit of a safe harbor from Section 8 of RESPA.

To be certified as a "small business" by the Small Business Administration, the annual receipts of a mortgage banker or mortgage brokers is not to exceed $6 million.[10] The next section discusses available data on small businesses in the mortgage market.

[9] Chapter 2 provides background information on the role of brokers in the mortgage market; brokers are mainly small businesses. Chapter 2's discussion of their market role is an input into the findings of Chapters 3 and 4 concerning the likely impacts of this proposed rule on the broker industry.

[10] The definition applies to firms with SIC code 6162, "Mortgage Bankers and Correspondents" and SIC code 6163, "Loan Brokers".

B.2 Data on Small Mortgage Businesses

Olson (2002) estimates that brokers receive an average of two points per loan (two percent of the principal balance) in receipts; in this case, a "small" brokerage business originates approximately $300,000,000 or less in loans per year.[11] At an average loan amount of $135,000, this translates into about 2,200 loans per year. By these estimates, "small" would include brokers (as well as lenders) closing 9 or fewer mortgage loans per business day. There is little doubt that there are a large number of mortgage brokers and lenders who originate fewer than 9 loans per day, and are thus classified as a "small business".

According to Olson (2002), there are over 30,000 brokers today, and they are typically small firms -- the median firm has five workers including the owner. Olson sees brokers as low-cost, highly-competitive firms, vigorously competing with one another and with little opportunity to earn above-normal profits. If normal profits suggest that each worker in a median-sized firm generated $125,000 in receipts, then total brokerage receipts would be $625,000 and total mortgage volume for the median-sized firm would be $31,250,000, also assuming 2 points per loan. This suggests that substantially more than half of the brokers would fall below the "small business" threshold of $300,000,000. Thus, provisions of the rule applying to brokers, for the most part, are also applying to small businesses.

HUD also examined Census Standard Statistical Establishment (SSEL) data maintained by the Small Business Administration.[12] Table 1.1 reports those data. Information for the year 1997 is provided for “Mortgage Bankers and Correspondents” and “Loan Brokers”, as well as for the combined total. While the broker information is based only on 8,392 brokers, some interesting trends are evident.[13] Using the less than $5 million receipts figure for 1997 as a proxy for the small business cutoff of $6 million in 2002, small brokers accounted for 97 percent of the reporting firms. They had, on average, 4.9 employees per firm, accounted for 75 percent of all broker employees, and 66 percent of industry receipts. In 1997, the average receipts for this group was $484,647 and the average receipts per employee was $98,2131.

Data for mortgage bankers and correspondents are reported in column 2 of Table 1.1. Small businesses in this group accounted for 88 percent of the reporting firms but accounted for only 27 percent of all employees and 12 percent of industry receipts. In 1997, the average receipts for small mortgage bankers and correspondent lenders was 605,698, and the average receipts per employee was $103,237. Similar data for settlement service providers are examined in Chapter 3.

[11] $300,000,000 times two percent (in receipts) would meet the $6 million cutoff for small business.

[12] The Census Bureau collects data annually on jobs and establishments by where the jobs and establishments are located. This series, known as the Standard Statistical Establishment List (SSEL), contains data on all establishments that file federal tax returns and have employees on their payroll. The SSEL data do not include public service employment, many non-profits, and sole proprietorships or partnerships with no employees.

[13] The broker data in Table 1.1 do not include sole proprietorships and partnerships without any employees.

IV. Nature of the Economic Impacts

Because the proposed rule calls for significant changes in the process of originating a mortgage, this Economic Analysis identifies a wide range of benefits, costs, efficiencies, transfers, and market impacts, which are summarized in Chapter 5. The anticipated benefits and efficiencies from improved borrower shopping could be substantial if the proposed rule is finalized. Ensuring that yield spread premiums are properly credited to borrowers in brokered transactions could cause significant transfers to borrowers. Similarly, increased competition associated with packaging could result in large reductions in settlement service costs, and associated income transfers from service providers who are earning "economic rents" in today's system to borrowers, who would most likely be the ultimate beneficiaries of more competition among settlement service providers. As these examples suggest, entities that experience reductions in revenues under the proposed rule are usually those who take advantage of uninformed borrowers, who are high-cost producers, or who are benefiting from the current system's restrictions on competition.

While the Economic Analysis will identify numerous anticipated benefits, and present evidence that these benefits are likely to be large and significant, it is difficult to quantify and provide precise estimates of these benefits. However, as will be shown in Chapters 3 and 4, not always being able to report the exact size of the benefits of the proposed rule will not undermine the desirability of the proposed rule, as it will be fairly convincing that the benefits of better disclosure, improved shopping, and increased competition among settlement service providers far outweigh any costs and negative effects associated with the proposed rule. Chapters 3 and 4 provide illustrative examples demonstrating the potential magnitude of the benefits to consumers of this rule; the substantial estimates of consumer benefits obtained derive mainly from applying the effects of improved borrower shopping and a more competitive third party settlement service industry to the sheer magnitude of mortgage transactions that take place each year. Improvements to the mortgage origination process are important because of the substantial size of the mortgage market.

Chapters 3 and 4 will also discuss anticipated impacts among different industry actors and market segments. Analysis of market effects and transfers is particularly important given concerns about small business. Again, while it will be difficult to reach firm conclusions about the precise nature of future market changes resulting from this rule, the analysis will examine market effects under a series of possible scenarios. The discussion will highlight factors that are likely to be important determinants of final outcomes. While much of this analysis is justifiably based on basic tenets of competitive market behavior, it is also necessary to consider market changes in the context of less competitive conditions, such as uninformed consumers and subprime markets.

Finally, the proposed RESPA rule offers a dual approach to settlement market problems – (1) a new, simplified GFE combined with tolerances on final settlement costs and a new method for reporting wholesale lender payments; and (2) a guaranteed cost approach based on packaging. Consumers and originators can use either approach, which has the advantage of allowing the market determine the best approach under a given set of circumstances. While there are reasons to expect originators to move toward the packaging approach, it is difficult to estimate the share of the market that will ultimately fall under packaging, as well as the timing of the move toward packaging. While the effects of the two approaches are basically similar, in terms of encouraging improved consumer shopping and lower settlement service costs, each approach has its own specific benefits, costs, transfers, efficiencies, and market impacts. Thus, the two approaches are discussed separately -- Chapter 3 discusses the new GFE approach while Chapter 4 discusses packaging.

V. Organization of the Economic Analysis

Chapter 2 mainly provides background material – it gives a brief overview of the mortgage market, highlights the role of major industry players such as brokers, and presents information on yield spread premiums. The benefits, costs, transfers, efficiencies, and market impacts of the proposed rule are discussed in Chapters 3 and 4. Chapter 3 discusses the new Good Faith Estimate, including the provisions of the rule that address the problem of lender payments to brokers. Chapter 4 discusses packaging, or the guaranteed cost approach. Chapter 5 provides a summary of the main benefits, costs, transfers, and efficiencies as well as the impacts on small businesses.

CHAPTER 2

OVERVIEW OF MORTGAGE ORIGINATION MARKET

This chapter provides a brief overview of the mortgage market as background for the discussion of the specific components of the proposed RESPA regulation. Mortgage origination trends are examined in Section I. The industry has shown a remarkable ability to handle substantial numbers of mortgage transactions over the past few years. In fact, heavy refinancing activity during 2001 led to a doubling of mortgage originations. Section II summarizes major developments in the mortgage market (such as the growth of the subprime market) and highlights the role of key industry actors (such as brokers and wholesale lenders). Section III provides background information on yield spread premiums, which have become increasingly used over the past few years as a mechanism for reducing upfront closing costs.

I. Mortgage Market Volume

As proposed, the rule will impact each mortgage transaction, including applications (which are the basis for a Good Faith Estimate) as well as originations (which are the basis for a HUD-1). The following data indicate the volume of business that will be impacted by the rule.

Based on industry estimates, single-family mortgage originations doubled during the 1990s, rising from $458 billion in 1990 to $1,024 billion in 2000, and then doubled again during the refinancing wave of 2001, rising to $2,030 billion. As shown in Table 2.1a, originations are highest during years of refinancing; for example, the refinance share was over one-half during the two peak origination years of 1998 ($1,507 billion) and 2001 ($2,030 billion). Industry forecasters expect refinancing to fall to 37 percent during 2002, which will reduce originations to $1,410 billion.

In terms of number of transactions, mortgage volume increased from an estimated 7.6 million single-family loans in 1997 to 8.2 million in 2000 before jumping to over 15 million in 2001. (See Table 2.1a.) Loan origination transactions averaged 11.1 million between 1997 and 2001 (or 8.9 million excluding the two heavy refinancing years).

While Table 2.1a focuses on mortgages that are actually originated, it is also important to look at loan applications, as a Good Faith Estimate is required for each loan application. Unfortunately, the industry sources that provided the origination data reported in Table 2.1a do not provide corresponding estimates of mortgage applications. To obtain application data, one must rely on data reported by lenders under the requirements of the Home Mortgage Disclosure Act (HMDA). While HMDA data underreport overall mortgage volume,[14] the data can be used

[14] HMDA's underestimation of mortgage originations can be seen by comparing Table 2.1a, which is based on industry estimates, with Table 2.2, which is based on HMDA data. For example, industry estimates place year 2000 mortgage volume at $1,024 billion while HMDA places it at $860 billion. Over the 1997-2000 period, HMDA-

to show the relationship between applications and originations. Table 2.2 reports application and origination data as reported by lenders under HMDA. In 2000, lenders reported $1,451 billion in mortgage applications, compared with $860 billion in originations, for a dollar-based applications-to-originations ratio of 1.69. Over the 1997-2000 period, the dollar-based applications-to-originations ratio averaged 1.58 while the transactions-based applications-to-originations ratio averaged 1.71. Table 2.1b applies these ratios to the industry origination estimates in Table 2.1a. As shown there, applications of $1,731 billion (15,463,781 applications) are implied by the industry mortgage origination estimate of $1,024 billion (8,269,402 originations) in 2000. If the rule were in effect during the year 2002, it would impact $2,383 billion in applications (covering 19,686,484 loans) and $1,410 billion in originations (covering 10,527,532 loans).

The application figures impacted by the proposed rule could be even higher than the estimates reported above. Under the proposed rule, the Good Faith Estimate (GFE) will be a better shopping document, so one would expect multiple GFEs per borrower. That is, borrowers will likely collect more than one GFE before making a final choice. This suggests that the applications-to-originations ratio could be higher with the new GFE than with today's GFE. However, it is difficult to estimate the increase in multiple GFE borrowers and mortgage applications.

II. Recent Developments and Main Actors in the Mortgage Origination Market

This section summarizes recent developments in the mortgage origination market, focusing on the major actors such as brokers. The discussion relies heavily on three recent papers (in addition to other referenced publications):

A. Michael G. Jacobides, "Mortgage Banking Unbundling: Structure, Automation, and Profit" *Mortgage Banking*, January 2001, pages 28-40.

B. Morgan Stanley, *US Mortgage Finance: The American Dream Industry, 2002-2020* (An industry analysis written by Kenneth A. Posner and Mita Nambiar), February 5, 2002.

C. David Olson, Prepared Statement at Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums" January 8, 2002 at http://banking.senate.gov/02_01hrg/010802/olson.htm

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reported originations (on a dollar basis) totaled about 84 percent of industry origination estimates. It should be noted that the HMDA data reported in Table 2.2 exclude loans from lenders that specialize in manufactured housing loans.

A. Jacobides' Paper

Jacobides documents the so-called "unbundling" of mortgage lending over the past 15 years. During the 1980s and 1990s, mortgage lending has evolved from the traditional portfolio lender model where single companies (bank and thrift depositories) performed all steps in the mortgage process -- making, closing, funding, servicing, and holding the loan – to a new atomized, more specialized industry of originators, funding lenders, warehouse lenders, separate secondary market buyers of loans, and servicers. A major driving force behind this unbundling of the mortgage functions was the rise and eventual dominance of mortgage securitization (led by Ginnie Mae, Fannie Mae, and Freddie Mac), which separated the provision of capital from loan origination and servicing. Increasing technical sophistication and information technology were also important factors in the restructuring of the mortgage finance system and the rise of mortgage securitization. Jacobides also notes that the traditional mortgage banking function (defined by independent mortgage bankers that sell their originations in the secondary market but retain servicing) has recently also been disintegrating, highlighted by birth of the mortgage brokerage function and the corresponding development of the wholesale segment:[15]

> "Now front-end loan origination is increasingly in the hands of mortgage brokers rather than mortgage bankers;…..specialized subservicers and focused wholesalers now mediate activities that used to be internalized within firms' boundaries…….Mortgage origination, in particular, has seen significant change….Mortgage brokers, for instance, who hardly existed before 1980, reportedly increased their origination volumes to as much as 65 percent of total originations over a few year's time span. Some mortgage bankers have shed their origination branch networks and have instead focused on wholesaling loans or restricted themselves to building networks of correspondent lenders. Still other mortgage banks focused on servicing…" (Jacobides, page 30)

As a result of the unbundling trend, the mortgage production process takes place in three different channels. LaMalfa (2001) estimates that in 2000, the retail channel accounted for 38% of total originations, the correspondent channel, 31%, and the brokerage channel, 31%.[16] LaMalfa notes that during the 1990s, each production channel accounted for approximately one-third of total production.

[15] Jacobides notes that the wholesale segment, which in 1989 accounted for 19 percent of all originations, reached 37 percent in 1993 and then stood at around 32-43 percent during the remainder of the 1990s.

[16] LaMalfa (2001) distinguishes between correspondents and brokers. Correspondents are closed-loan sellers; they fund their obligations by drawing down funds from warehouse lines they establish and maintain with creditors. Brokers, on the other hand, are originators without warehouse lines of credit; they close their loans through either (a) table funding or (b) concurrent funding arrangements. In both cases, the wholesale lender funds the loan at closing. The difference between (a) and (b) depends on whose name is on the mortgage and who handles closing. In the case of (b), concurrent funding, the wholesale lender's name is on the loan rather than the broker's and the lender, not the broker, handles closing. In the case of (a), table funding, the broker's name is on the loan and the broker handles closing. It should be noted that LaMalfa's definition of brokers follows the HUD definition of brokers; the remaining "brokers" (as the term is typically defined) have warehouse lines of credit and they probably show up as correspondents in LaMalfa's classification system.

B. Morgan Stanley Report

Morgan Stanley examined recent changes in the origination market, as a basis for making market projections over the next few years. Some of main findings from the Morgan Stanley analysis are summarized below; Morgan Stanley echoed several of Jacobides' points.

Morgan Stanley concludes that the prime mortgage market is highly competitive and efficient, and that brokers are an important reason for this. The report notes that "tens of thousands of independent brokers" have competed away business from traditional (small and medium-sized) banks and thrifts, and Morgan Stanley does not foresee any reversal in this trend. According to Morgan Stanley, brokers are not hampered by high fixed costs (due to maintaining a large in-house sales force, for example) and are flexible enough to respond to the extreme cyclicality of the mortgage origination function. This was demonstrated in 2001, when brokers doubled their originations in response to the substantial increase in refinancing activity. Morgan Stanley says there is little evidence of economies of scale in mortgage origination and cites evidence that brokers are more efficient originators than mid-size and large lenders.

The Morgan Stanley report emphasizes that technology and automated underwriting systems are making big changes in the mortgage industry in areas such as servicing, pricing, connectivity, and unit costs. Brokers are increasing using technology supplied by lenders and the GSEs when submitting loans for electronic approval. Morgan Stanley also concludes that the spread of automated underwriting and "open architecture" systems (allowing brokers to quickly qualify applicants and obtain prices from several lenders) should further improve brokers' price sensitivity and competitive position (also see discussion below of Forrester report).

Morgan Stanley notes that despite the trend toward dis-integration, there has a rise in a handful of mega wholesale lenders with efficient business processes and low costs. These lenders -- such as Countrywide, Wells Fargo, Chase Manhattan, and Washington Mutual -- have been a byproduct of the recent consolidation process in the banking and thrift industries. They serve as wholesale lenders purchasing loans from brokers and correspondents as well as operating their own retail operations. The share of the top 15 retail lenders more than doubled from 27% to 56% between 1994 and 2000; the share of top 15 wholesale lenders purchasing loans from brokers and correspondents exhibited a similar increase since 1994. Morgan Stanley concludes that this industry concentration will improve competitive rivalry in the origination and wholesale process as episodes of irrational pricing will be less frequent.

With respect to overall competition in the prime mortgage market, Morgan Stanley echoed the comments of Jacobides, who said that intense competition has reduced mortgage fees by almost 40 percent in recent years. Morgan Stanley sees advances in technology continuing the trend toward lower origination costs. Given the commodity-like nature of mortgages and the price sensitivity of consumers, Morgan Stanley sees the cost savings from technology advances being quickly passed through to consumers, with little increase in lenders' profit margins.

With respect to the impact of technology advances on small lenders and brokers, a report by Forrester Research, Inc. entitled "Resuscitating Mortgage Lending" echoed many of the sentiments of the Morgan Stanley report.[17] The Forrester report, based on interviews of lenders, stated that the benefits of the automated underwriting (AU) systems deployed by the GSEs and third-party vendors have accrued mainly to smaller lenders and brokers. The fact that the GSEs' systems go directly to brokers means that brokers do not have to rely on the AU systems of large lenders. The GSE systems enable brokers to make fast decisions (without collecting a lot of paperwork or committing to a specific lender), to shop their GSE-accepted mortgages among lenders for the best deal, and to accomplish all this without having to make a large investment in technology infrastructure. Even on important issues such as credit risk, brokers can often rely on the GSE and private mortgage insurance automated systems, without having to be tied down to specific rules of large lenders.

C. Olson's Analysis of the Broker Industry

The most complete information on the characteristics of mortgage brokers and the rise of this sector during the 1990s comes from David Olson, who has conducted several surveys of the brokerage industry.[18] Olson summarized his findings about the industry during his recent testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (see #3 above). Some of Olson's points include the following:

> Brokers increased their share of the origination market from practically zero in 1980 to 20% in 1987 to 55% in 2000, and then to 65% during the heavy refinancing wave in 2001.[19] Brokers accounted for $1.3 trillion (or 65%) of the $2 trillion of mortgages originated during 2001.
>
> There are 33,000 brokers today. These are typically small firms -- the median firm has one office and five workers including the owner. The median firm is only five years old. The median firm originated 200 loans in 1998 and 125 loans in 2000.[20] Olson sees brokers as low-cost, highly-competitive firms, vigorously competing with one another and with little opportunity to earn above-normal profits.[21]

[17] Forrester Research, Inc., *Resuscitating Mortgage Lending*, May 2001.

[18] In fact, others commenting on the industry, such as Morgan Stanley, rely heavily on Olson's research.

[19] Olson defined a broker as any independent (not connected with a bank, thrift, or credit union) firm who table funds more than half its production, doesn't service loans, and doesn't buy whole loans from other firms. This broker definition includes brokers that use lines of credit to finance up to half their production; it is therefore broader than the definition used by HUD and LaMalfa (2001) (see earlier footnote). As discussed in the text, LaMalfa estimates that approximately one-third of mortgage production has come through the brokerage channel (defined as table funding and concurrent funding) while another third has come through the correspondent channel. Olson's larger estimate that brokers account for about 60 percent of market originations is due to his more expansive definition that covers brokers with warehouse lines of credit that also operate through correspondent arrangements with larger wholesale loan purchasers (rather than simply table funding loans).

[20] Based on summaries of Olson's annual surveys of the mortgage market, which can be found at http://www.wholesaleaccess.com. Olson also reports that his surveys find no economies of scale in mortgage production – a one-person firm produced as many loans per employee as a larger firm.

[21] Research is reported in Section III below that suggests brokers overcharge borrowers by not giving them the full benefits of yield spread premiums; this seems inconsistent with Olson's statements about the absence of above-

> Olson concludes that brokers are particularly needed in today's volatile mortgage market, as they can grow and contract their work forces much more quickly than existing retail firms. According to Olson, brokers were the main reason the industry was able to handle the refinance-induced doubling in mortgage origination demand during 2001.

The above discussion suggests that, in general, the nation's mortgage market is efficient and competitive. Combined with the growth in the secondary market, advances in the primary origination market have allowed homeowners to quickly obtain financing at reasonable interest rates that reflect the unique risks (e.g., credit and prepayment risk) of mortgages relative to benchmark Treasury securities. Compared to the traditional depository-based system that dominated home funding as recently as the early 1980s, the current system provides homeowners with ready access to both national and global capital markets.

This does not mean that everyone has ready access to mortgage credit or that all aspects of the mortgage market operate in an efficient and least costly manner. The preamble to the proposed RESPA rule and Chapters 3 and 4 below outline several problems with the mortgage shopping and settlement (closing) processes that have raised concerns of fairness and cost-effectiveness, even in the prime (or so-called "A") part of the mortgage market. The complexity of the origination process, combined with the fact that consumers have limited experience taking out mortgages, place a premium on having a process that is simple, easy to understand, and clear about the various mortgage options available to the consumer -- unfortunately, the current mortgage shopping process is too often characterized as confusing and providing little useful information to guide the consumer in making a final decision. The costs of settlement can not only be too high -- thereby combining with the down payment requirement to serve as an up-front barrier to homeownership for lower-income families -- but they can also be uncertain and subject to change between initial application and final closing, further frustrating consumers in their efforts to obtain homeownership. In addition, there are opportunities for further innovation in the mortgage origination process through packaging and other methods that would allow lenders to provide services at a lower cost. Chapters 3 and 4 below will discuss these issues and concerns in more detail and explain how the RESPA Rule seeks to correct them and thereby improve the shopping and settlement process.

The remainder of this section will first discuss the subprime mortgage market and predatory lending, where the above concerns are even more serious than in the prime market. After that, some background information is provided on yield spread premiums, which have recently spread throughout the market as a method for borrowers to trade-off higher interest rates for reduced up-front settlement costs. As noted in the introduction, a major objective of the

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normal profits in the broker industry. It is possible that brokers and other originators overcharge some borrowers (say the less informed borrowers) and undercharge other borrowers (say the more informed borrowers) with the end result being that the firms earn, on average, normal profits. In addition, it is possible that firms that overcharge borrowers also have excessive marketing costs (trying to attract such borrowers), which again would be consistent with normal profits. Possibly, there could be other factors leading to these two seemingly irreconcilable conclusions.

proposed RESPA rule is to provide a reporting format that ensures that consumers receive the full benefits of the yield spread premiums associated with above-par interest rate loans.

D. Subprime Market

The subprime market provides loans to borrowers who cannot qualify for prime loans because of their poor credit records and high levels of debt. Subprime lending increased substantially during the 1990s, rising from $35 billion in 1994 to $173 in 2001. As a percentage of total mortgage originations, subprime lending was over 12 percent during 1999 and 2000 before falling to 9 percent during the refinance wave of 2001. During 2001, brokers accounted for 41% of subprime originations, retail lenders for 39%, and correspondent lenders for 20%. Subprime loans are mainly refinance loans, and are often used for debt consolidation.

The subprime market allows borrowers who can't qualify for conventional loans (or even FHA loans) to receive a loan by paying a higher interest rate to offset their higher credit risk; essentially, the growth in subprime lending has represented the first real expansion of risk-based pricing in the mortgage market. Without the subprime market, many lower-income, credit-impaired borrowers would not have been able to obtain funds during the 1990s (Gramlich, 2002). Because they face higher interest rates and origination fees due to questions about their creditworthiness, borrowers in the subprime market are precisely the people who need the simplification and shopping advantages offered by the types of reform outlined in the proposed RESPA rule. As noted below, there exists some inefficiency in the subprime market, which places a premium on consumers shopping in order to obtain useful information regarding mortgage options and prices.

The joint HUD-Treasury report, *Curbing Predatory Home Mortgage Lending*, explains the origins of this market, the factors behind its substantial growth, and the characteristics of borrowers served by that market. The report also discusses some of the concerns that have come with the growth in this market. First, there is evidence of inefficiency in pricing, which is not entirely surprising given the heterogeneous nature of borrowers served by this market and the rapidity with which the market has grown.
Analysis by Freddie Mac economists suggests that some borrowers in this market are paying higher interest rates than would be predicted by their credit scores and other loan characteristics.[22] Both GSEs have also said that a significant number of subprime borrowers could qualify for conventional prime loans. This points to the importance of consumers shopping their qualifications among a number of lenders so as to gain information about the full range of mortgage options available to them.

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[22] See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000. Also, analyses by Fannie Mae and Freddie Mac suggest that some portion of subprime lending is occurring with borrowers whose credit would qualify them for loans sold to the GSEs. Freddie Mac staff estimate that 10-35 percent of subprime borrowers meet Freddie Mac's purchase guidelines for conventional loans. Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae. See "Fannie Mae Vows More Minority Lending", *Washington Post*, March 16, 2000, page EO1.

Second, HUD studies have documented that minority borrowers rely heavily on subprime lenders for their refinance mortgages.[23] In 1998, subprime loans accounted for 33 percent of all refinance mortgages going to black borrowers, compared with only 8 percent for white borrowers. Other research has shown that regulated prime lenders (i.e., bank and thrift institutions) often were not operating in high-minority neighborhoods, in effect, leaving them to unregulated, subprime lenders (Immergluck and Wiles, 1999. This led to calls for prime lenders to increase their presence in underserved neighborhoods.

Finally, there is evidence that predatory lending has been an unfortunate part of the growth in the subprime market. Predatory lending is characterized by several abusive and horrendous lending practices – excessive interest rates, outrageous origination fees and points rolled into the mortgage, pressure tactics to refinance so that another set of high upfront fees can be charged, and so on. Predatory lenders target the elderly, women, and minorities who need money quickly to pay for medical expenses, pay off credit cards or make needed house repairs. There is no quantitative information on the magnitude of predatory lending (i.e., the number of loans with predatory characteristics), and there are questions about how exactly to define it. However, there is ample anecdotal information from victim testimonies and various court cases to indicate the seriousness of this problem and the variety of forms it can take.

III. Background Information on Yield Spread Premiums

Upfront cash for a down payment and closing costs is perhaps the main obstacle that families face when considering homeownership. The 1990s saw a host of low-down-payment programs offered by conventional lenders to address the issue of down payments. The industry also came up with a closing-cost-financing option for cash-constrained borrowers, who are at their maximum loan-to-value ratio and are therefore prevented from further increasing their loan amount to finance closing costs. Under this option, commonly known as yield spread premiums, borrowers can finance their closing costs, either fully or partially, by getting a loan with an above market interest rate. Above-market-interest-rate loans are priced at greater than par value (par value being equal to the loan amount); the excess of this price over par value is defined as the yield spread premium. In the case of a broker selling an above-market-rate loan to a wholesale lender, the broker receives a yield spread premium equal to the difference between the wholesale price of the loan minus the loan amount. With a zero-closing-cost loan, the broker uses the yield spread premium as compensation for mortgage closing costs; in this case, the borrower would not pay any closing costs but would have higher monthly payments because of the higher interest rate on the mortgage note.[24] In the same manner, borrowers can also fund a portion of their

[23] The *Unequal Burden* report published by HUD (April, 2000) reported similar data on a neighborhood basis -- subprime lending accounted for 51 percent of the refinance loans in predominantly black neighborhoods, compared to only 9 percent in predominantly white neighborhoods. This work is updated in Scheessele (2002).

[24] Of course, yield spread premiums are not confined to wholesale lender and broker transactions. Portfolio lenders, who do not sell their loans on the secondary market, would pay a yield spread premium on an above-market-rate loan because of the higher return (i.e., the above market rate) they receive over the life of the loan. Mortgage bankers may fund a loan with a line of credit and hold the loan for a period of time prior to selling it on the secondary market. For these types of transactions, Chapter 3 below discusses the implications of not being able to measure the yield spread premium at mortgage closing.

closing costs (rather than all of them) through loans with above-market interest rates. In fact, the idea behind yield spread premiums is that borrowers would be offered a range of interest-rate, closing-cost combinations and the borrower would choose the one that best suits his circumstances.[25]

There has been some controversy about how yield spread premiums are being used in the market. For example, some argue that yield spread premium payments from wholesale lenders to brokers do not offset borrower closing costs (on a dollar-for-dollar basis), as they are designed to do. Rather they are seen as providing extra compensation for brokers, with borrowers not receiving the full benefits of the above-market-rate loan. Others, on the other hand, argue that yield spread premiums are doing their job, providing a vehicle for cash-constrained borrowers to finance their closing costs. As noted in Chapter 3, the proposed RESPA rule establishes a disclosure and reporting system that guarantees borrowers in broker transactions will receive the full credit for yield spread premiums associated with above-market-rate loans that they choose.

Because of the proprietary nature of lender files, there is not much public information on yield spread premiums and mortgage closing costs. The information that is available is based on industry surveys and studies that have been conducted as part of recent court cases. The remainder of this section summarizes the limited information that we have about yield spread premiums and their relationship to mortgage closing costs.

Basic Facts. As noted above David Olson has conducted several surveys of the mortgage industry that focus on the business operations of mortgage brokers. In recent testimony before Congress, Olson (2002) noted that about 2 percent of the loan amount (or $2,800) is required to compensate brokers for their cost, time, and profit in originating mortgages.[26] According to Olson, most buyers either don't have that amount of cash or prefer to finance the fee. In addition, Olson estimates that 45 percent of the income of mortgage brokers comes from yield spread premiums (paid by wholesale lenders to brokers) while 55 percent comes from direct fees paid by borrowers.

Howell E. Jackson (2002) also provides some descriptive information based on his analysis of a sample of approximately 3,000 mortgages originated by a group of affiliated lending institutions in the late 1990s.[27] Approximately 85 percent of Jackson's sample had yield

[25] It should be noted that borrowers who are not at their maximum LTV ratio may also prefer a loan with a yield spread premium. It may be more economical for a borrower who plans to stay at his current residence only a short time to finance closing costs through a high interest rate loan (that would be shortly prepaid when the borrower moved), rather than paying closing costs up-front with cash. Borrowers may also prefer to use their available cash for other uses.

[26] Again, the notion discussed below that brokers have not passed on to the consumers the full benefits of yield spread premiums seems inconsistent with Olson conclusion that brokers are earning zero economic profits; on the other hand, the fact that there are so many brokers (and lenders) is consistent with his conclusion that brokers operate in a highly competitive origination market.

[27] Jackson undertook this analysis as an expert for the plaintiff class in Glover v. Standard Federal Bank, Civil No. 97-2068 (DWF/SRN) (U.S. District Court of Minnesota) (pending). Jackson also draws on the larger paper he did with Jeremy Berry; see Jackson and Berry (2002), "Kickbacks or Compensation: The Case of Yield Spread Premiums."

spread premiums. For these loans, the total compensation to brokers[28] was similar to the number reported above by Olson -- $2,548 to $2,852 or slightly over 2 percent of the loan amount; the average yield spread premium was $1,850 per transaction.

The market's use of yield spread premiums is also suggested by analysis of FHA data. Table 2.3 reports the distribution of interest rates for 30-year fixed-rate mortgages for the month of May 2001. When these loans were locked in, the average interest rate on a "par" value FHA-insured loan was about 7.25 percent, or even slightly less.[29] As shown in the third column of Table 2.3, 44 percent of FHA-insured loans had an interest rate above 7.25 percent, suggesting that yield spread premiums were common in the FHA market, although not nearly as prevalent as in Jackson's sample of loans. It is interesting that 36 percent (fourth column) of FHA-insured loans had an interest rate equal to or greater than 7.5 percent; and 9 percent had an interest rate equal to or greater than 8.0 percent. In general, a 7.5 percent mortgage in a 7.25 percent environment is priced about one point over par ($1,000 on a $100,000 loan) and an 8.0 percent mortgage is priced about 2.5 points over par ($2,500 on a $100,000 loan). Thus, there were significant YSPs in the FHA market.[30]

The other indication that yield spread premiums are being used in the market is based on data for conventional home purchase loans from the Federal Housing Finance Board (FHFB). The FHFB data show that the average initial fees and charges on mortgages have fallen from 1.87 in 1990 (when yield spread premiums were first being used in the market) to less than one since 1998 (e.g., 0.75 in 2000). This trend suggests that yield spread premiums have increasingly been used to finance borrower closing costs.

Statistical Studies of the Impact of Yield Spread Premiums. There is no academic literature examining the extent to which the presence of a yield spread premiums results in an offsetting reduction in direct payments of closing costs by the borrower. However, the findings of two empirical studies that were conducted as part of a recent court case[31] have been reported in Congressional Testimony by the authors (Jackson, 2002; Woodward 2002), as well as in a more detailed article co-authored by Jackson (Jackson and Berry, 2002). The results of their analyses will be briefly summarized below.

Both Howell J. Jackson and Susan Woodward examined the same data as part of the court case, Glover v. Standard Federal Bank. Jackson (2000), serving as an expert witness for the plaintiffs, concluded that, for the most part, yield spread premiums are not being used to lower direct fees paid by borrowers. Based on his regression analysis, Jackson concluded that

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[28] Defined as yield spread premium plus loan origination fees plus other compensation minus offsets for settlement costs paid by the mortgage broker. See page 87 of Jackson and Berry (2002).

[29] From March 1 through April 13, FHA rates averaged slightly over 7.0 percent. They jumped to 7.13 percent on April 13 and were 7.37 for the last week in April.

[30] The same patterns were observed the two other months (April and June) that were analyzed.

[31] See above reference to Glover v. Standard Federal Bank.

borrowers gain (as an offset to their closing costs) only about 25 cents on each dollar of YSP; the other 75 cents of YSP ends up as compensation for the broker.[32] Woodward (2002), serving as an expert witness for the defendant, reached different conclusions based on analysis of the same sample, noting that Jackson's analysis was incomplete because it failed to consider many factors that cause variation in broker compensation. Woodard says the sample data suggest that borrowers' up-front costs are reduced by 84 percent of the average YSP. In her more sophisticated regression analysis (as reported by Jackson and Berry, 2002), Woodward finds that 74 percent of the yield spread premium offsets borrowers' closing costs. Jackson and Berry (2002) also reports that Professor George Benson, another expert witness for the defendant, obtain similar results to Ms. Woodward. The end result is that experts for the defendant (Benson and Woodward) conclude that YSPs offset borrower closing costs to a much greater extent than the expert for the plaintiff (Jackson).[33] As noted earlier, the proposed RESPA rule establishes a disclosure and reporting system that guarantees that YSPs will fully offset closing costs, giving borrowers in broker transactions full credit for any YSPs associated with above-market-rate loans.

Another issue that is frequently mentioned in the context of YSPs concerns whether lenders are clearly explaining to shoppers that YSPs represent one of several options that the shopper can voluntarily choose. While there is little hard data on this, some claim that lenders are not informing consumers of various options, but rather focusing them on above-rate mortgages with YSPs. Jackson (2002a) states that, in his experience, YSPs are not described as an optional way to finance closing costs and that consumers are not given enough advice to compare the higher monthly payments over the life of above market-rate loan with the savings in closing costs due to the YSP. As explained in Chapter 3, an attachment to the new Good Faith Estimate requires that lenders show lower-interest-rate and higher-interest-rate options to the selected loan indicated on the GFE. The intention is to reinforce that lenders provide consumers with a variety of interest rateand closing cost options so that the consumer can choose the option that best suits his circumstances.

[32] While it is recognized that uninformed borrowers can be taken advantaged of by lenders, Jackson's findings that 75 percent of yield spread premiums ends up as extra compensation for brokers seems inconsistent with the notion that the origination market is competitive. But as explained next, other researchers have obtained smaller estimates of what is retained than Jackson. Also see earlier footnote on this issue.

[33] Jackson and Berry (2002) criticizes both sets of results, much as Woodward (2002) criticizes Jackson's work.

CHAPTER 3

THE NEW GOOD FAITH ESTIMATE AND RELATED CHANGES

I. Introduction

This chapter discusses the new Good Faith Estimate, including the provisions of the rule that address the problem of lender payments to brokers; Chapter 4 will discuss guaranteed packaging, which is the other major provision of the proposed rule. The proposed rule addresses the problem of lender payments to mortgage brokers by fundamentally changing the way in which these payments in brokered mortgage transactions are recorded and reported to consumers. The proposed rule also changes the Good Faith Estimate (GFE) settlement cost disclosure and related RESPA regulations to make the GFE simpler, firmer, and more usable to facilitate shopping for mortgages, to make mortgage transactions more transparent, and to prevent unexpected charges to consumers at settlement.

Organization of Chapter. The remainder of this introductory section summarizes the various changes related to the Good Faith Estimate (subsection A) and lists the major benefits and market impacts of the new GFE, including the effects on small businesses (subsection B). Sections II-VIII explain in more detail the anticipated benefits and impacts associated with the proposed new Good Faith Estimate. The discussion is organized around the following topics: role of originator (Section II); treatment of premium and discounts (Section III); consolidation of the Good Faith Estimate (Section IV); tolerances (Section V); trade-off of interest rates and points (Section VI); other GFE topics (Section VII); and compliance and other costs (Section VIII). Section IX summarizes economic and market effects associated with the new GFE. Section X summarizes estimates of the benefits, costs, transfers, and efficiencies asscociated with the new GFE approach. Appendix A discusses an alternative GFE approach that was considered.

A. Overview of the Main Components of the New Good Faith Estimate[34]

Sections I and III of the preamble of the proposed rule discuss the problems that led to HUD's proposal for changing the Good Faith Estimate and the treatment of lender payments to brokers. Under current rules, there is some confusion concerning the role of the mortgage broker, and how the broker is compensated. There is no assurance that payments from wholesale lenders to brokers (i.e., yield spread premiums) are always applied to help offset consumers' settlement costs (see Section III in Chapter 2). In addition, the current GFE format contains a long list of charges that often overwhelms consumers and certainly does not inform them what the major costs are so that they can shop and compare mortgage offers among different originators.

[34] Readers not interested in this summary of the proposed rule provisions may want to proceed to Section I.B which summarizes the main benefits and impacts of the new GFE.

First, the proposed rule would address the problem of lender payments to mortgage brokers by revising the GFE to:

1. Inform the consumer that mortgage brokers and lenders do not offer loans from every source and cannot guarantee that its loan terms are the best in the market, and that the consumer is responsible for shopping for a mortgage;
2. Explain to the consumer the option of paying settlement costs through the use of lender payments based on higher interest rates (i.e., yield spread premiums) or reducing the interest rate by paying the lender additional amounts at settlement (discount points);
3. Require, in transactions originated by mortgage brokers, that payments from a wholesale lender for above-par loans (yield spread premiums) be reported on the GFE and the HUD-1 Settlement Statement as a lender payment to the consumer. As explained below, these changes will ensure that consumers receive the full benefit of any payments from or to wholesale lenders, either (a) by reducing their up front settlement costs in exchange for accepting a loan with a higher interest rate, or (b) by reducing their interest rate and monthly payments by paying additional amounts (discount points) to the lender at settlement.

Second, the rule would improve the existing RESPA disclosure regime by establishing a new required format for the Good Faith Estimate providing greater simplicity, accuracy, and usefulness for consumers. This framework would better inform mortgage borrowers of the costs of obtaining a mortgage loan from a mortgage broker, as well as from mortgage bankers, lenders or other loan originators, and would better protect borrowers from unnecessary surprise charges at settlement. It also would provide firmer and more usable estimated cost disclosures so borrowers can more effectively shop and compare the cost associated with mortgages to lower settlement costs. The new GFE would:

1. Include an interest rate quote and notification of any prepayment penalties to assist the consumer in comparison shopping among mortgages;
2. Disclose subtotals of major categories of settlement costs (including, for example, loan origination costs and title services) to consumers to eliminate the proliferation of fees and to allow consumers to focus on the major fees; and
3. Provide additional shopping information for consumers that would (a) provide a breakdown of lender and broker charges, as well as title insurance and title agent charges; and (b) inform the consumer of lender required lender-selected services and those third party services that can be shopped for by the borrower.

Finally, the proposed rule would implement new rules for the provision of the GFE so that loan originators:

1. Clarify the basic information needed in an "application" to obtain a GFE;
2. Limit consumer fees for the GFE, if any, to the amounts necessary to provide the GFE itself;
3. Establish tolerances that require that loan originators adhere to the amounts reported in the GFE regarding their own compensation, lender-required-and-selected-third-

party services, government charges, and the daily per diem rate through settlement (absent unforeseeable and extraordinary circumstances);

4. Require that originators comply with upper limits or "tolerances" so that their charges for other major settlement charge categories cannot exceed those stated on the GFE by more than 10%;[35] and,
5. Clarify that loan originators can make arrangements with third party settlement service providers to lower prices for their customers, provided these prices or any fees on the GFE are not "marked up" or "up charged."

B. Summary of the Rule's Benefits and Impacts on Small and Other Businesses

The main benefits, costs, transfers, and market impacts of the new GFE approach are outlined below, along with the specific impacts on small businesses. The new GFE format in the proposed rule will improve consumer shopping for mortgages, which will result in better mortgage products, lower interest rates, and lower settlement costs for borrowers. The proposed rule also ensures that consumers in brokered transactions receive full credit for taking on a high interest rate loan.

Chapter 2 noted that most brokers are small businesses. The impacts on brokers of the new GFE approach are highlighted below and are discussed throughout this chapter. As also noted below, settlement service providers who are small businesses would also be impacted by any reduction in settlement service prices arising from the tighter tolerances on settlement fees.

Shopping Benefits

- The new GFE format in the proposed rule simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement over today's GFE, which contains a long list of individual charges that encourages fee proliferation and junk fees, and can often overwhelm and confuse consumers.

- The new GFE contains a statement that clarifies the role that the originator plays in the loan process. It states, for example, that the originator does not distribute the loan products of all funding sources, that the originator does not guarantee the best loan terms, and that the consumer should shop. This will put all borrowers on notice that they should protect their interests by shopping.

- The new GFE also makes cost estimates more certain, by requiring that loan originators adhere to amounts reported on the GFE for major cost categories (such as origination fees), and on additional cost categories give estimates subject to a 10% upper limit, or tolerance. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement.

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[35] The tolerance applies when the borrower uses a service provider recommended by the lender; it does not apply if the borrower selects a service provider that is not recommended by the lender.

- The new GFE will better inform consumers about their financing choices by requiring that lenders explain the different interest rate and closing cost options available to consumers. For example, consumers will fully understand the trade-offs between reducing their closing costs and increasing the interest rate on the mortgage.

- Altogether, the simplicity and certainty offered by the new GFE should improve comparison shopping for mortgage loans, reduce interest rates and settlement prices for borrowers, and eliminate surprises at settlement. There will be less of the sub-optimal consumer shopping that often characterizes today's mortgage market. In addition, originators will be less able to take advantage of uninformed shoppers.

Summary of Estimated Impacts

- Under one set of assumptions, Section III.D estimates that $7.5 billion of the $15 billion in total yield premium payments (YSPs) is not passed through to borrowers to reduce closing costs. If the proposed rule results in half of this $7.5 billion being recaptured by borrowers, then the annual impact would be $3.75 billion. While this figure will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on the return of YSPs to borrowers as reduced closing costs.

- Direct origination fees are estimated to be $15 billion (which when added to the $15 billion in YSPs results in total originator compensation of $30 billion). In addition to the $3.75 billion in YSPs recaptured by borrowers, it is also assumed that improved shopping enables borrowers to capture five percent (or $0.75 billion) of originators' direct origination fees of $15 billion.

- Section V estimates that $18 billion in third-party fees would be subject to increased price pressure as a result of the imposition of tolerances and expanded shopping by originators. While it is difficult to estimate how much tolerances and expanded originator shopping will reduce the $18 billion, this figure provides a base on which this effect will be felt. The estimates reported below assume that third-party fees would fall by 10 percent, or $1.8 billion.

- It was estimated that borrowers would save $6.3 billion in annual settlement charges.[36] This $6.3 billion represents transfers to borrowers from higher priced producers, with $4.5 billion coming from originators[37] and $1.8 billion from third party settlement service providers. While these figures will vary depending on

[36] As explained in Section IV.C, the $6.3 billion represents about 13 percent of the baseline settlement costs, which include origination fees and selected third party costs (appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges). Survey, pest inspection, and mortgage insurance are not included, as they are not required on all loans. Thus, the $6.3 billion may be a conservative figure. This assumes, of course, that all the other assumptions underlying this scenario are correct.

[37] The $3.75 billion in YSPs recaptured by borrowers plus the $0.75 billion in reduced ' direct origination fees give $4.5 billion in transfers to borrowers from originators.

specific assumptions, it provides a sense of how large the effects of the proposed rule could be on settlement charges to borrowers.

- In addition to the transfers, there are several efficiencies associated with the GFE (see the summary in Section X). Borrowers realize $826 million savings in time spent shopping for loans and third party services. Loan originators save $1.280 billion in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save $350 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. Some or all of the $1.280 billion and $350 million in efficiency gains have the potential to be passed through to borrowers through competition.

- Costs to originators rise by $226 million if it takes 10 extra minutes to handle the forms and by $26 to $52 million to make third party arrangements in response to tolerances. (See "Costs and other Impacts" below.)

- As discussed throughout this chapter, the benefit, cost, transfer, and efficiency estimates are based on specific assumptions. The estimates provide a sense of the overall net benefits of the proposed new GFE approach to consumers. The rest of this summary highlights the main impacts of the new GFE approach.

New Treatment of Wholesale Lender Payments and Impacts on Brokers

- The proposed rule ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with an above-par interest rate, that is, yield spread premiums will go directly to the borrower. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through directly to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs.

- Similarly, the proposed rule ensures that in brokered transactions, consumers who choose to pay discount points receive the full market benefit in terms of lower mortgage interest rates.

- Under these new rules, brokers must report the total origination fees they receive on the GFE and the HUD-1 -- rather than their origination fees <u>net</u> of any yield spread premium they receive. Thus, the new GFE clarifies what brokers are receiving for loan origination.

- Chapter II explains that most brokers are small businesses. The above changes in the method for reporting wholesale lender payments on the GFE and HUD-1 will reduce the incomes of those brokers who have been overcharging consumers by receiving a combination of origination fees and yield spread premium payments that is greater than that suggested by competitive markets. The new GFE will clearly indicate both

(a) the broker's total origination fee received and (b) the net upfront origination fee to the borrower, after reduction for any yield spread premium that the wholesale lender pays the borrower. Consumers will have full information about broker fees, which will allow them to comparison shop and pay lower fees, compared with the situation they face in today's market.

- As explained in the proposed rule, it is not practical to implement such a system for lenders, which means that lenders can continue to report their origination fees on a net basis if they so choose.[38] However, HUD has designed the new GFE form so that it reduces any anti-competitive effects between brokers and lenders. For purposes of comparing lender and broker offers, the new GFE focuses the borrower's attention on the right number, which is the subtotal after reducing total origination fees by any lender payment to the borrower (i.e. yield spread premium). This should reduce any anti-competitive impacts of the proposed rule on small businesses.

- Furthermore, it is anticipated that market competition will increase the likelihood that yield spread premium payments will be passed through to borrowers throughout the market, in lender (i.e., non-broker) as well as broker transactions. The information that consumers gain from broker transactions concerning the money back on premium loans should make consumers act competitively with respect to premiums on similar loans from non-brokers.

- Brokers as a group will remain highly competitive actors in the mortgage market. Chapter II discusses the factors that will continue to keep brokers competitive with other lenders. As noted above, HUD has also designed the GFE to lessen any anti-competitive effects from the different reporting requirements of lenders and brokers on the new GFE. Therefore, there is no evidence to suggest that there would be any major anti-competitive impact on the broker industry as a whole from the new GFE provisions in the proposed rule.

- Rather, the main impact on brokers (both small and large) of the proposed new treatment of payments by wholesale lenders would be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums. As noted above, it is anticipated that market competition, under this new GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high yield spread premiums and origination costs.

- As noted above, according to some estimates, $7.5 billion in YSPs is not passed through to borrowers to reduce closing costs. While this figure will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on the return of YSPs to borrowers as reduced closing costs.

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[38] This also includes those brokers who have wholesale lines of credit.

Lower Settlement Service Prices

- The imposition of tolerances on fees will encourage originators to seek discounts and cut settlement service prices. The proposed rule clarifies that loan originators can make arrangements with their third party settlement service providers (appraisers, settlement service agents, etc.) to lower prices for their customers (i.e., borrowers), provided these prices or any fees on the GFE are not "marked up" or "up charged."

- To the extent that third party settlement service providers happen to be small businesses, they, of course, would experience a reduction in their revenues, due to the reduction in settlement service prices.

- Section V examines the magnitude of third-party fees that would be subject to increased price pressure as a result of the imposition of tolerances and expanded shopping by the originator. As noted above, $18 billion in third party fees would fall into this category. While it is difficult to estimate how much tolerances and expanded originator shopping will reduce the $18 billion, this figure provides a base on which this effect will be felt. The estimates reported above under "Summary of Estimated Impacts" assumed that third-party fees would fall by $1.8 billion, or 10 percent. It was estimated that small settlement service providers would account for 70 percent of this $1.8 billion decline in fees. But as discussed in Section V.C, this estimate is subject to variation.

Costs and Other Impacts

- There are some direct costs to originators from complying with the GFE portion of the proposed rule. These do not appear to be very large. While the new GFE format requires less itemization than today's GFE, the HUD-1, with its detailed itemization, remains essentially the same. Originators and closing agents will have to expend some minimal effort in explaining to consumers the cross walk between the new streamlined GFE and the more detailed HUD-1. There is a new page of the GFE showing interest rate alternatives, which should not impose much additional costs, given that most originators do that in some form today. As noted above, costs to originators rise by $226 million if it takes 10 extra minutes to handle the new GFE form.

- There will be some costs to originators from the need for additional preliminary underwriting in order to generate new GFEs. While this underwriting is already occurring for full applications today, it is expected that some borrowers under the new GFE will get multiple applications and use them to shop. However, it is difficult to estimate how many additional GFEs and preliminary underwritings will result under the new GFE scheme. In addition, as discussed in Section VIII.A, the number of applicants going to full underwriting could decline under the proposed rule.

- The imposition of zero and 10 percent tolerances on fees will require lenders to take some actions that will increase their costs. For example, arrangements will have to be made with third party settlement service providers, in order for the originator to come up with estimates that can be delivered within the 10 percent tolerance. (See above estimates.)

Small Business Impacts – A Summary and Alternatives Considered

Section IV.C estimates that $3.5 billion of the $6.3 billion in transfers would come from small businesses. The above summary bullets highlight the mechanisms through which this is expected to happen. Improved consumer shopping among originators and more aggressive competition by originators for settlement services will lead to price reductions. Originators (both small and large) and settlement service providers (both small and large) that have been charging high prices will experience reductions in their revenues. Of the $3.5 billion impact on small businesses, Section IV.C estimates the $2.2 billion will come from small originators and $1.3 billion, from small settlement service providers.

Market impacts on different types of businesses are discussed throughout this Chapter, as well as in the above summary bullets. Section III.C and Appendix A discuss impacts on brokers and lenders and alternative policies that HUD considered when developing the rule. Examples of alternatives that HUD considered that would impact small businesses include:

- One alternative considered was to place the interest rate dependent payment at the bottom of the new GFE form rather than directly after the origination charge. This was rejected since an unsophisticated borrower might misinterpret the broker's higher origination charge (relative to a lender who can net the yield spread premium out of the origination charge rather than list it separately as a lender payment to the borrower) as indicating that the broker's loan is more costly.

- The Department considered placing the division of the origination charge into broker and lender portions on the front page of the GFE but rejected that idea since the information was not useful in bottom line comparison shopping. Loans with identical origination charges from brokers will now have the same number presented in the origination charge on the front of the form, regardless of how the fee is broken down between the broker and the lender.

- The Department considered having zero tolerance on both the lender and broker components of the origination charge instead of zero tolerance on the total. Zero tolerance on the components would have given brokers less flexibility in switching lenders, even if the total of the lender and broker fees would remain the same. The method selected makes it easier for brokers to switch lenders, so long as the total origination charge does not rise.

- The Department considered having different statements of the services of the originator in Section I of the new GFE. The purpose of this section of the GFE is to alert borrowers to shop in order to protect their interests. Different statements could favor brokers over lenders, or vice versa. The Department adopted the idea that every originator would have to deliver the same message, so that every borrower gets the same warning and no originator is at a disadvantage in delivering the message.

II. Description of the Role of the Originator

The GFE contains a statement describing the role the originator plays in the loan process. It states that the originator uses either its own funds or the funds of others, does not distribute the loan products of all funding sources, does not guarantee the best loan terms, and that the consumer should shop. The purpose is to put all borrowers on notice that they should protect their interests by shopping. This statement is included because some borrowers are confused about the role of a broker in originating a loan. Thus, there should be less confusion on the part of the borrower and the sub-optimal search resulting from that borrower confusion should be eliminated.

As an alternative, the Department considered having two different forms, one for brokers with a statement of function and one for lenders. But there is much confusion in the market[39]. First, only those originating in the name of another and those using table funding are brokers in the Department's definition of a broker, so only they would have to use the Department's broker disclosure that puts the borrower on guard. However, since many borrowers are not familiar with HUD's unique definition of broker, they might mistakenly believe that their broker is an agent and not shop to the extent that they would have otherwise. Rather than leaving that borrower with no statement of function, it was decided to give all borrowers the same statement and implied warning about shopping. Another good reason for doing this is that many originators act as lenders in one loan and brokers in another. In fact, they might even switch from one mode to another after giving the GFE. The single GFE makes it simpler for all in these cases. A third reason for the single form was to make sure that neither kind of originator was given any inadvertent advantage from the content of the disclosure.

III. Treatment of Premiums and Discounts

The Department decided to change the instructions for the reporting of loan premiums and discounts in brokered loans in order to improve disclosure and in the hope that premiums and discounts will be fully utilized to offset closing costs or buy down the interest rate respectively. This change is presented before the discussion of the general changes to the GFE since it is independent of the other proposed changes to the GFE.

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[39] The Department has a unique definition of a "mortgage broker" that includes one who originates a loan in the name of another and one who originates in his own name but utilizes table funding. The Department defines "lender" to be the named lender on the mortgage document or the provider of funds in a table funded transaction. Many use the term "broker" in a broader sense than the HUD definition and would include those who, for example, use a warehouse line of credit or their own funds to finance originations where the intention is to sell the loan and servicing rights. The brokers in a broader sense who do not fit the HUD definition of a "broker" are "lenders" for the purposes of RESPA and do not have to meet any "broker" reporting requirements for yield spread premiums or other indirect fees. The term "broker" will be used here in the HUD defined sense.

A. Background

As explained in Section I.A above, the proposed rule would fundamentally change the way in which mortgage broker compensation is reported by requiring in all loans originated by mortgage brokers, that any payments from a wholesale lender based on an above par interest rate on the loan (payments formerly denominated "yield spread premiums") be reported on the Good Faith Estimate (and the HUD-1 Settlement Statement) as a lender payment to the borrower. Additionally, that any borrower payments to reduce interest rate ("discount points") must equal the discount in the price of the loan paid by the wholesale lender, and so reported on the GFE (and HUD-1). These changes would require mortgage brokers to disclose, at the outset, the maximum amount of compensation they could receive from a transaction, in the "origination services" block of the GFE. They would then disclose the amount of the lender payment to borrower that would be received at the interest rate quoted, if any. Mortgage brokers would be unable to increase their compensation without the borrower's knowledge, by placing the borrower in an above par loan, or by retaining any portion of the lender payment or the borrower payment for "discount points." Through these changes in reporting requirements, HUD believes that virtually all disputes regarding broker compensation in table funded transactions and intermediary transactions involving "yield spread premiums" will be resolved. Maximum broker compensation will be clear and brokers will have no incentive to seek out lenders paying the largest yield spread -- they will, instead, be motivated to find the best loan product they can for the borrower.

B. Discussion of Premiums, Discounts and Benefits

Both brokers and lenders may make loans at interest rates above or below par. If the rate is above par, the stream of monthly payments will be greater than otherwise. If the loan is sold, the market price for that loan will be higher than for a loan with a par rate. Buyers will offer a premium for the stream of higher monthly payments. Lenders have the option of keeping the loan in portfolio and earning the premium over time or selling the loan and getting the premium as a lump sum from the investor who will earn the higher payments for the life of the loan.[40] The yield spread premium (YSP) is the premium value, or value above par, of the loan and is realized upon sale of the loan. It is created, implicitly, upon creation of the above-par interest rate loan. Those originators who keep the loan in portfolio have an implicit YSP equal to the present value of the increase in monthly payments associated with the loan. It becomes recognizable in an accounting sense when the loan is sold.

Conversely, loans made at lower than par rates have lower monthly payments generating lower market prices for such loans. Buyers will buy these loans only at a discount. This discount (sometimes called discount points) is implicitly created at origination but realized in an accounting sense upon sale of the loan (although it would be included in any market valuation of the loan).

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[40] Some will hold the loan for a while and then sell it, getting a combination of the two.

Originators usually offer mortgages at various rates above and below par. Higher rate loans may lead to lower loan origination fees paid by the borrower, or even money back in some cases, as a result of yield spread premiums that are realized upon sale or simply implicitly created upon origination. Lower rate loans often generate charges to borrowers for discount points to offset the discounted market value of the loan.

Currently, brokers are required to report the dollar value of yield spread premiums on the GFE and HUD-1 as going from the wholesale lender[41] to the broker and paid outside of closing (POC). Other originators, lenders, do not report yield spread premiums since they are either realized in the secondary market and are exempt from reporting requirements or are unrealized since the loan has not been sold. If the loan has not been sold by the time of the closing, there is no readily available indisputable value for the premium. The value is readily available at closing in a brokered transaction. In a transaction where the broker uses table funding, the premium price of the loan is available at closing. In the case of a broker who originates in the name of another, the lender's payment based on the rate would be available as well.

There are no specific requirements for the reporting of discounts. For lenders, the sale, if any, is considered a secondary market transaction. Unlike the case of yield spread premiums, there is no requirement in brokered transactions for the discount points charged to the borrower to equal the discount in the transaction between the broker and the wholesale lender. For example, the broker could charge the borrower two discount points while the price paid to the broker by the wholesale lender is in excess of 98. The broker's direct charge to the borrower may exceed the charge from the wholesale lender to the broker as reflected in the price of the loan.

Thus all originators have the potential to increase their compensation by generating yield spread premiums that exceed the reduction in other fees charged to the borrower or by charging the borrower more in discount points than is warranted by the wholesale value of the loan. That is, the originator can profit by failing to reduce other charges by the full amount of a yield spread premium or by overcharging for discount points. This is the problem that much of the public discussion on broker compensation has focused on, particularly the yield spread premium. Section III of Chapter 2 reported estimates of the extent to which yield spread premiums offset borrower settlement costs. As noted there, the few empirical estimates that are available exhibit rather wide variation. HUD's proposed rule would ensure that yield spread premiums fully offset borrower costs in broker transactions.

Under the proposed rule, lenders may continue to operate as before.[42] Neither the fact that the loan has not yet been sold nor the secondary market exemption will change. Brokers, however, must now comply with two new requirements. First, any premium in the price of the loan must go back to the borrower in the form of an explicit credit to cover closing costs. Under HUD's proposed GFE and HUD-1 process, the broker is not a party to this payment from the

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[41] The term "wholesale lender" will be used to describe the lender in a brokered loan.

[42] The problem that YSPs are not available for lenders who have not sold the loan remains and the secondary exemption that shields secondary market transactions from RESPA coverage still exists.

wholesale lender to the borrower. Brokers may no longer supplement their stated explicit fees with somewhat obscure indirect fees from wholesale lenders.

This solves the yield spread premium problem in brokered loans. It would be hard to imagine a disclosure that would be more likely to get the attention of the borrower than completely out in the open and prominently displayed money back. So the borrower would have to be aware of the existence of the premium under the new GFE. In addition to the enhanced borrower awareness of the premium, it is completely used to offset closing costs. It cannot be used to supplement other disclosed broker fees. This is a far cry from the current system that reports yield spread premiums outside the buyer's and seller's columns in cryptic terms like "Yield spread premium POC"[43] that are likely to be meaningless to the average borrower and do not require a dollar for dollar offset to closing costs.

It should be noted that with brokered loans, the forced return of any premium to the borrower to offset up-front fees means that brokers can only get paid for what is included in direct fees for origination services. All broker income must be derived from direct fees while lenders who originate may continue to supplement their direct fees with yield spread premiums that continue to be unreported to borrowers. This may give lenders a competitive advantage over brokers (see discussion below).

Second, all discount points or fees charged to the consumer must equal the discount reflected in the price of the loan. The broker may no longer profit from charging the borrower more in discount points than the wholesale lender charges the broker. Again, all broker income must be derived from payment for origination services. Again, lenders who originate loans are unaffected by this part of the proposed rule and may have a competitive advantage over brokers. This will be addressed in more detail below.

B. Market and Economic Impacts

The new requirement for the wholesale lender in a brokered loan to pass through premium prices and discount points directly to the borrower may adversely affect the competitive position of brokers as compared to lenders; however, as explained below, HUD has designed the new GFE to reduce any anti-competitive effects between lenders and brokers. While lenders may continue to simply reduce explicit fees in the presence of premium rate loans, brokers may not.[44] Suppose a broker and a lender are offering the same terms on a loan, and both have the same origination services fee, $3,000 and the same other settlement costs, $4,000. Assume that the rate on each loan is the same and higher than par and that the premium value of the loan is the same for both originators, $2,000. Currently, both originators could simply quote $1,000 for originator fees and keep the yield spread premium of $2,000. The broker would have to report the yield spread premium as $2,000 and paid outside of closing while the lender would

[43] "POC" is Paid Outside Closing.

[44] Sales of loans by lenders are considered "secondary market transactions" which are exempt from RESPA scrutiny by HUD regulation. Even if they were not exempt, the premiums are often not available at closing. For example, the loan may never be sold, the loan may be sold after closing with the price unknown at closing, or only part of the loan gets sold

report nothing. Both would report the other settlement costs of $4,000 and the total due from the borrower would be $5,000.

Under the proposed new reporting arrangement, lenders could continue to report originations fees of $1,000 and show it on line A (see Table 1). The lender can continue as before and show no credit, so $0 can be put on line B. The lender origination fees subtotal would also be $1,000. Other settlement costs would be $4,000 and the settlement cost total would be $5,000. On a brokered loan, the interest rate dependent payment would have to show the $2,000 as a lender payment to the borrower and it would be shown as -$2,000 since it goes to the borrower instead of from the borrower (see Table 2). In order for the originator to get $3,000, the origination fee would have to show $3,000. The origination fees subtotal would be $1,000, the other settlement cost would be $4,000, and the settlement cost total would be $5,000.

Table 1

SETTLEMENT COSTS			
A. ORIGINATION FEES	$1,000		
B. INTEREST RATE DEPENDENT PAYMENT	0		
NET LOAN ORIGINATION CHARGE		$1,000	
C-K (OTHER SETTLEMENT COSTS)	$4,000		
TOTAL SETTLEMENT COSTS			$5,000

Table 2

SETTLEMENT COSTS			
A. ORIGINATION FEES	$3,000		
B. INTEREST RATE DEPENDENT PAYMENT	-2,000		
NET LOAN ORIGINATION CHARGE		$1,000	
C-K (OTHER SETTLEMENT COSTS)	$4,000		
TOTAL SETTLEMENT COSTS			$5,000

A knowledgeable shopper would ignore A and B and go to the origination fees subtotal to see the originator segment of the cost of this loan, as shown by the "NET LOAN ORIGINATION CHARGE" in Tables 1 and 2. It would be the same for the lender and the broker, $1,000. In other words, putting the $1,000 NET near the top of GFE means that shoppers will not be confused between lender and broker GFEs and their respective offers. One might want to include the other settlement costs as well if there were no reason to believe that the differences in the other settlement costs were misleading in any way.[45] In that case, the settlement cost totals are the same, $5,000. The knowledgeable shopper would conclude these two loans cost the same and the borrower would be indifferent between the two loan offers. In these cases, there would be no adverse impact on the broker relative to the lender.

A potential problem comes where a shopper is not knowledgeable. A lender trying to convince a borrower to take his loan instead of the broker's might focus the borrower's attention on the reported origination fee the two charge: $3,000 for the broker (Table 2) and $1,000 for the lender (Table 1). The lender would try to keep the borrower's focus away from the numbers that show the same total cost (i.e., the NET LOAN ORIGINATION CHARGE) and constantly emphasize the $2,000 additional fee charged by the broker. In the case of borrowers who cannot see through this erroneous argument, the lender will appear cheaper than the broker and is more likely to get the borrower's business. In fact, borrowers whose attention is focused on the origination fee might be persuaded that a loan from a lender (Table 3 on next page) with higher total cost than from a broker (Table 2) is better for them based on their comparison of the origination fees alone. These potential outcomes highlight the importance of creating a GFE where the borrower's attention is overwhelmingly focused on the right numbers for comparison shopping purposes**.** The proposed GFE is designed to reduce any competitive effects between brokers and lenders.

Table 3

SETTLEMENT COSTS			
A. ORIGINATION FEES	$1,500		
B. INTEREST RATE DEPENDENT PAYMENT	0		
NET LOAN ORIGINATION CHARGE		$1,500	
C-K (OTHER SETTLEMENT COSTS)	$4,000		
TOTAL SETTLEMENT COSTS			$5,500

What if, on the other hand, borrowers make the error of focusing on the interest rate dependent payment variable? What if some borrowers like big lender payments to borrowers? It must be remembered that there is no restriction placed on lenders concerning their payments to borrowers. Any lender could put on the form the same numbers (or larger numbers) that would show up on a brokered loan.

[45] One lender might list prices on the GFE that he knows he can deliver, while another lists lower figures such that he can deliver the GFE numbers times 1.1 so that he just meets the 10% tolerance. A later settlement could lead to a larger or smaller per diem interest charge depending on whether you go beyond the end of the month. The same is true for an earlier date. Escrow deposits depend on the size of the cushion that can change immediately upon sale of the loan.

The Department has placed the interest rate dependent payment right after the fee for origination services so that the netting is done immediately and the net up-front loan charges are easy to find. Nonetheless, there will probably always be some borrowers who will still make mistakes and compare the wrong numbers when comparison shopping. The new GFE broker requirements that treat brokers and lenders differently may result in misinterpretations of the loan fees; the placement of the interest rate dependent payment is intended to limit such misinterpretations.

If lenders are able to earn higher profit as a result of the change in disclosure requirements in the new rule, we would expect to see brokers try and become lenders by acquiring warehouse lines of credit to finance loan originations instead of using table funding. If there were any efficiencies in these originators being brokers (using table funding) rather than lenders (using warehouse lines of credit), these efficiencies will be lost. In order to minimize these effects, the consumer should be clearly informed that the net loan cost, the lender origination fees subtotal, is the correct number to focus on when comparing the up front loan cost among loans.

Finally, it should be noted that brokers as a group will remain highly competitive actors in the mortgage market. Chapter 2 discusses the factors that will continue to keep brokers competitive with other lenders. As noted above, HUD designed the GFE to lessen any anti-competitive effects from the different reporting requirements of lenders and brokers on the new GFE. Therefore, there is no evidence to suggest that there would be any major anti-competitive impact on the broker industry as a whole from the new GFE provisions in the proposed rule.

Rather, the main impact on brokers (both small and large) of the proposed new treatment of payments by wholesale lenders would be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums. It is anticipated that market competition, under this new GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high yield spread premiums and origination costs.

Alternatives Considered. In developing the proposed rule, the Department considered several alternative policies that relate the rule's impact on brokers (or small busineses). One alternative, discussed in Appendix A to this chapter, was to place the interest rate dependent variable at the bottom of the form after all of the other settlement costs, which would have highlighted how the yield spread premium can be used to partially or fully cover total settlement costs. The idea was that borrowers would get this subtotal and see how much cash they needed to come up with to close, and then decide how much of the settlement costs they wanted to pay through a higher interest rate, or how much they would pay up-front to lower the interest rate on the loan. Rather than this alternative, the Department chose (as discussed above) to place the interest rate dependent variable directly after the origination charge, coming up with a net origination charge, which is highlighted in the new GFE. This was done to minimize the chance of an unsophisticated borrower missing the premium payment to the borrower as offsetting the broker's origination charge and thinking brokered loans were more costly than non-brokered loans.

Another alternative considered the division of the origination charge into broker and lender portions, which is now off the front page of the new GFE form. The Department considered placing it on the front page but rejected that idea. It reduces the prominence of a difference that would appear in otherwise identical loans when the only difference is in the type of originator. Loans with identical origination charges from brokers will now have the same number presented in the origination charge on the front of the form, regardless of how the fee is broken down between the broker and the lender. The removal of the breakout from the front page makes it less likely that shoppers will be confused.

The Department considered having zero tolerance on both the lender and broker components of the origination charge instead of zero tolerance on the total. Zero tolerance on the components would have given brokers less flexibility in switching lenders, even if the total of the lender and broker fees would remain the same. The method selected makes it easier for brokers to switch lenders, so long as the total origination charge does not rise.

In Section I of the new GFE, the Department considered having different statements of the services of the originator for brokers and lenders. The purpose of this section of the new GFE is to alert borrowers to shop in order to protect their interests. If this were required only of brokers, then brokers would be telling their customers to shop, look elsewhere, while lenders would not have to tell their customers the same thing. That would not be equal treatment and would place brokers at a disadvantage. Also, some borrowers might think that an originator who fits the broad definition of a broker is their "shopper" and that they do not have to shop to protect their interests. They are misinformed and need this disclosure in order to be aware of how to protect themselves. Thus the Department adopted the idea that every originator would have to deliver the same message. Every borrower gets the same warning and no originator is at a disadvantage in delivering the message.

D. Yield Spread Premiums – Estimated Magnitude

As discussed above, yield spread premiums could be affected for several reasons. First, in brokered loans, disclosure of the YSP is improved by the requirement that YSPs must be passed from the lender to the borrower in their full amount and be disclosed as such on the GFE and HUD-1. Second, alternative interest rate/up front fee combinations must be presented to illustrate how payments change with the different options. Third, shopping in general is enhanced with the new GFE. The combined effect of these may lead to a greater application of YSPs to offset loan closing costs.

Chapter 2 projected that approximately $1.5 trillion in loans will be originated in 2003 (see Table 2.1a). David Olsen (2002) estimates that 60% of these are originated by brokers, in a broad sense of the word ($900 billion). It is assumed that half of these are HUD-defined brokers ($450 billion), which results in $450 billion in loans originated by HUD-defined brokers. Olson estimates that brokers collect 2% of the origination amount as fees ($9 billion) and that 45% of that comes from yield spread premiums.[46] For simplicity, we will use 50% (rather than 45%) so that total yield spread premiums on HUD-defined brokered loans comes to $4.5 billion.

Jackson (2002) estimates that only a quarter of yield spread premiums are used to offset closing costs, so that three quarters is additional profit to the broker. Woodward (2002) estimates that about three quarters offsets closing costs, so that a quarter is additional profit to the broker. (See Chapter 2.) Using these estimates as brackets, then from $1.125 to $3.375 billion has the potential to be a transfer back to the borrower who has a yield spread premium on a brokered loan. For simplicity, the midpoint, $2.25 billion, will be used.

The proportion that goes back to the borrower depends on the effect of the new disclosure concerning alternative interest rate/up front cost combinations and the effect of reporting the yield spread premiums as lender payment to the borrower. This increase in good information to the borrower might put broker fees under even more competitive pressure.

But is there any good reason to limit these transfers to those who used a HUD-defined broker? Other brokers might not appear any different to the borrower than a HUD-defined broker who uses table funding. In fact, the only difference to the borrower is that the broker who does not fit the HUD definition does not even report the yield spread premium as 'POC," so that the borrower is even more in the dark on this matter.

It could be argued that since these brokers still do not have to report any "lender payment to the borrower for higher rate," they will be under less pressure to use it to offset closing costs. But under the new GFE approach any borrower who has had the explanation of the trade-off from any originator should have improved awareness of the yield spread premium principle, and any borrower who has gotten even one other GFE for a premium loan from a broker will have gotten the complete explanation of the lender payment to the borrower. So borrowers seeking loans from non-HUD-defined brokers might well be as aggressive as those seeking loans from HUD-defined brokers. It is assumed that other brokers originate as many loans as HUD defined brokers, 30% of the market. Therefore, the potential return to borrowers in the non-HUD defined broker portion of the market equals $2.25 billion if all the assumptions in the first paragraph remain the same. In fact, since there is no disclosure at all of yield spread premiums in this portion of the market today, the amount returned might be an even greater portion of any yield spread premiums.

Finally, what about the remaining lender (or non-broker) 40% of the market? Again, the borrower may have no idea about the "broker" status of an originator. And the improved awareness effect discussed in the paragraph above might apply just as well here. If so, there is the potential to return $3.0 billion to borrowers from this portion of the market.

Thus, the potential to be returned to the borrowers who pay interest rates consistent with yield spread premiums regardless of the kind of originator is $7.50 billion.[47] Again, there are

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[46] Jackson (2002) estimates 65% of broker income in loans with yield spread premiums comes from yield spread premiums.

[47] $2.25 billion for HUD-defined brokers, $2.25 billion for non-HUD-defined brokers, and $3.0 billion for lenders (or non-brokers).

many simplifying assumptions behind this illustrative analysis, such as the assumption that YSPs are equally prevalent in all three market segments and that the average loan size is the same as well. But this exercise provides some indication of the order of magnitude of the effects. The effects are large.

Another question concerns how much of the above $7.5 billion is accounted for by small businesses (or small loan originators). Data in Table 1.1, with some additional manipulations, suggest that small businesses account for at least half of the total, although there is uncertainty around this estimate.[48]

IV. Consolidation of the Good Faith Estimate: Shopping Advantages

A. Description of the New Good Faith Estimate

Another feature of the proposed rule is to change the presentation of information on the GFE. See Exhibit A. Single entries for various settlement service providers or groups of providers will substitute for the detailed itemizations currently required. The goal is to simplify and summarize the information to make it easier to comparison shop. It will also lead to the elimination of the fee itemization that goes beyond that required by law, sometimes referred to as "junk fees," that can lead to higher loan costs.

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[48] Table 1.1 can be used to estimate the percentage of total originator receipts (and therefore total mortgage originations under the assumption that originator receipts represent 2 percent of total originations) accounted for by small businesses. There are four steps. (Step 1) First, it is assumed that brokers account for 60 percent of the market and non-brokers account for 40 percent of the market. (Step 2) Then, the following procedure was used to estimate the small business share of the broker business. As shown in the last column of Table 1.1, the 8,392 brokers included in the Census data had $5.954 billion in receipts (8,392 times average firm receipts of $709,551). These data include only brokers with a payroll and do not include sole proprietorships or partnerships without an employee payroll. Assuming for the moment that there are 30,000 brokers and that the remaining approximately 22,000 brokers are single-person firms with average receipts of $110,000 (see average receipts per employee for all firms), one derives $2.439 billion in receipts for this group. Adding the $5.954 billion and the $2.439 billion gives total receipts of $8.394 billion for brokers. Repeating this same process for small brokers (as proxied by the "less than $5 million in receipts" in Table 1.1) suggests that small brokers account $6.089 billion in receipts. As shown in Table 1.1, small brokers account for 96.6 percent (or 8,106) of all the 8,392 brokers which yields $3.928 billion in receipts (8,106 times average firm receipts of $484,647 for small brokers); assuming all the remaining 22,000 brokers are small businesses with average receipts of $98,231 (a different number than assumed above) yields an additional $2.161 billion in receipts for small brokers, or a total of $6.089 billion. Under this calculation, small brokers represent 82 percent ($6.089 billion divided by $8.392) of broker receipts; this calculation may overstate the small broker share because of the above assumption that the remaining 22,000 brokerages were single-person firms. As shown in Table 1.1, small brokers represent 66.0 percent of the receipts of the 8,392 brokers. Thus, one assumption might be that small businesses account for three-fourths of broker business – about half way between 66 percent and 82 percent. (Step 3) Table 1.1 shows that small businesses (those with less than $5 million in receipts) account for 12.4 percent of "mortgage banker and correspondent" receipts but, again, it is not clear how many small "mortgage bankers and brokers" are excluded from the Census sample. In addition, this figure does not include other non-brokers such as commercial banks and thrift institutions; but large banks and thrifts probably dominate the bank and thrift business. (Step 4) Applying the market shares from step 1 (60% for brokers and 40% for non-brokers) and assuming small business shares in steps 2 and 3 (75% for brokers and 12% for non-brokers) yield an overall average share for small business of about 50 percent. As suggested by the numerous assumptions behind these calculations, the small business share could vary from this estimate.

Originators will no longer produce a list of fees itemizing lender charges. All originator fees for loan origination will be included in one charge called "origination services." As discussed above, the premium or discount associated with the interest rate chosen by the borrower will be listed separately since brokers using table funding must put down the right number and earn only fees included in "origination services." Even though lenders do not have to put down the right value for the premium or discount, the blank is available to them if they choose to include any value there. The important value for the consumer in comparing different loans is the combination of the two since the combination is the relevant net burden on the borrower for choosing a particular loan; this is the "NET LOAN ORIGINATION CHARGE" in Exhibit A.

The next category is non-title lender-required third party services selected by the lender. These would often include appraisal, credit report, flood certificate, and tax service, which are usually selected by the lender. They might include a pest inspection or a survey. Non-title services that the borrower has no choice about are lumped together on the GFE.

The settlement agent and title insurance are next as one figure rather than a potentially long itemized list of fees that relate to them. These are grouped together because these charges are usually the result of making one choice of who is to provide these services. The detailed breakdown into a long list of fees seems unimportant. There will be an indicator for whether the borrower or lender makes the choice of who provides these services.

Then comes lender-required third party services that are selected by the borrower which are separate from the lender-required third party services selected by the lender, because the borrower's choice can influence how much these cost. Examples could be a pest inspection or a survey.

Government taxes and other fees are separate since they are involuntary, equal for identical loans, and are, for the most part, not for any service rendered.

Escrow is separate for a few reasons. One is that the borrower has to pay these charges eventually anyway. Another is that differences could result from one originator using a low cushion relative to another originator, but that low cushion could disappear as soon as the loan is sold to another servicer who could charge to make up the full cushion after settlement. Borrowers who are comparing loans would want to make any necessary adjustments so that the escrow account charges are comparable.

Per diem interest is itemized because it depends on the date of settlement. In some cases, the borrower might want to compare loans as if the settlement date were the same. Another point is that this charge is for the use of money to own the home for the remainder of a payment period (part of a month, for example) until the regular amortization begins. So as this fee is higher, the home buyer also gets to move in earlier in the month.

Homeowner's insurance is a separate item since the price is dependent on the coverage selected on the homeowner's policy. It could vary according to the tastes of the borrower.

Coverage could vary according to an umbrella policy, jewelry coverage, boat coverage, contents coverage, and a host of other considerations. Other than basic coverage required by the lender, these are all up to the borrower and might be the same regardless of the originator chosen.

Optional third party services include borrower's title coverage, home warranty, etc. These are separate since they are not required to get the loan. The last category is in case the other categories above do not cover all the potential fees.

B. Shopping Benefits from the New Good Faith Estimate

The new GFE will improve the ability of the consumer to shop. There are several reasons to believe that shopping will be enhanced by this rule. First, the presentation is simpler, with figures combined into functional categories, so that borrowers are less likely to be overwhelmed by detail. Second, the estimates on the GFEs are more reliable which will make it more likely that decisions based on this information will make the borrower better off. Third, the estimates will be received earlier giving the borrower more time to shop. Fourth, in some cases they will be given at lower cost so that more loan options may be compared. All of these factors make it likely that consumers will obtain loans at lower cost. When a borrower does a better job shopping and receives a loan at more favorable terms, there is a transfer from the originator to the borrower. We would expect this to result from more shopping.

But there is an additional effect beyond simply the effect that a borrower who shops more has on himself. With more borrowers shopping more effectively in the mortgage market, the originator who sought to exploit the badly informed borrower will find fewer victims in the market. Targeting these victims will become a less profitable strategy since fewer of their applicants will take loans with more costly terms. There will be a tendency for these lenders to leave the industry or change their marketing tactics to try and get the borrowers who are more in the mainstream. This increases the chances that even a poorly informed borrower who could easily become a victim would get more competitive offers when searching for a loan. So shopping has direct benefits to the shopper and indirect benefits to all other borrowers, whether shoppers or not. In either case, there is pressure for prices to fall and the result is transfers from originators to borrowers.

The increased ease of shopping will benefit both the prime and sub-prime markets. In the prime market, the uninformed borrower can be taken advantage of by an aggressive originator who tries to get the borrower to agree to costly terms. The uninformed borrower who does not shop is a potential victim. As mentioned above, the increase in shopping should benefit both those who increase their shopping and have spillover benefits to others by decreasing the likelihood that they will run into an aggressive lender looking for victims

The subprime market has an additional complication. Most prime borrowers correctly assume their credit status and shop on that assumption. Prime loan information is easy to access in the market and that facilitates comparison shopping. Subprime borrowers have a more difficult time comparison shopping. First, subprime borrowers do not know exactly what their credit status is without going through underwriting. Second, even if they know their credit status as evaluated by one originator, that status could be different with another originator due to a lack of standardized underwriting criteria. So, in today's subprime market, the borrower who wants to comparison shop must go through underwriting for each originator from whom he gets a loan quote. This could be very costly for the borrower. Under the new GFE in the proposed rule, comparison shopping should be much easier because the loan terms offered on the GFE are based on at least some underwriting. While the cost in time and money may not fall to the level of the prime market, the new GFE is an improvement over the current scheme available in the subprime market.

C. Shopping and New GFE – Estimated Magnitude of Effects

According to Olson (2002), the average broker makes 2 points per loan, or $2,700 per loan at an average loan amount of $135,000. Adding $1,600 in third party fees (discussed below in Section V.C), this comes to $4,300 per loan in origination and third party fees. That figure times 11,111,111 loans[49] results in $48 billion going to the originator and third parties. This is the base upon which any price reductions from all the effects of the proposed rule would have their effect.

As discussed in Section III.D, half ($15 billion) of total fees ($30 billion) to the originator are assumed to be derived from the premium rate. Of this $15 billion, it is estimated that $7.5 billion has the potential to be reflected in reduced charges to the borrower. It is assumed that half that amount, $3.75 billion, will find its way back to the borrower.[50] Other assumptions could be made.

As discussed below in Section V.C, a conservative estimate of third party fees comes to $18 billion. This is the amount that would come under the effect of tolerances, allowing the originator to seek out discounts on behalf of his borrowers, and the simplified GFE. It is assumed that there will be a 10% fall in these prices as a result, saving borrowers $1.8 billion.

The remainder of the fees ($15 billion) going to the originator, aside from the $15 billion in YSP discussed above, will be subject to the effect of tolerances and increased shopping (but not the effect of the originator seeking discounts, since the originator does not shop for its own services). This $15 billion is assumed to fall by 5%, for a savings to borrowers of $0.75 billion.

Under this set of assumptions, the estimated price reduction to borrowers comes to $6.3 billion, or about 13 percent of the $48 billion in total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges).[51]

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[49] Mortgage originations are assumed to be $1.5 trillion (see Chapter 2). At an average loan amount of $135,000, the number of mortgages is 11,111,111.

[50] Or in other words, it is assumed that the proposed new GFE approach (with its new treatment of lender payments) results in 25 percent ($3.75 billion divided by $15 billion) of existing yield spread premiums being returned to borrowers as offsets to closing costs. See Section III.D for further discussion of this assumption.

[51] Survey, pest inspection, and mortgage insurance are not included, as they are not required on all loans. Thus, the $6.3 billion may a conservative figure, assuming, of course, that all the other assumptions underlying this scenario are correct.

Thus, there is an estimated $6.3 billion in transfers from firms to borrowers from the improved disclosure and treatment of yield spread premiums and more and better shopping due to the improved GFE. Originators contribute $4.5 billion of this and third party settlement service providers, $1.8 billion. This benefit to consumers comes from reduced overcharges that competition passes on to borrowers. It is estimated that $3.5 billion of the $6.3 billion comes from small businesses -- $2.2 billion from small originators and $1.3 from small settlement service providers.[52] In addition, there will also be efficiencies associated with the shopping incentives of the new GFE. Borrowers will save time shopping for loans. If the new forms save the average applicant one hour in shopping time, borrowers will save $661 million.[53] Originators will save time as well. If half the borrower time saved comes from less time spent with originators, then originators spend a total of half an hour less per loan originated talking to borrowers for a saving of $680 million.[54]

There are other potential shopping efficiencies that are anticipated from the new GFE approach but would be difficult to estimate. Many people (and particularly low-income and minority families) feel that the process of getting a loan to buy a home is complicated, mysterious, and intimidating.[55] All of these features will be reduced under the new rule. Many of those who have the financial resources and credit along with the desire to own a home shy away from the process as a result of these negative features. These people may decide to become homeowners under the new schemes as these deterrents to homeownership are reduced. While there is good reason to believe the new scheme will be viewed more positively by potential homebuyers, we see no way to quantify this beneficial impact and the time it takes to occur. But the new GFE approach outlined in this chapter should increase the certainty of the lending process and, over time, should reduce the fears and uncertainties expressed by low-income and minority families about purchasing a home.

Sections VIII and X below will report additional efficiency gains, as well as costs, associated with the new GFE.

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[52] Section III.D explains that small originators are expected to account for one-half of the origination effect ($4.5 billion above) and Section V.C explains that small settlement service providers are expected to account for 70 percent of that effect ($1.8 billion above).

[53] This calculation is based on applicants, rather than borrowers. It is assumed that the number of applicants (18,888,888) is 1.7 times the number of borrowers (11,111,111). Year 2000 HMDA data show that the average borrower income is $73,000, or $35 per hour based on 2,080 hours per year. Multiplying the 18,888,888 applicants times $35 yields the $661 million reported in the text.

[54] This assumes $72 per hour for originator's time (or $150,000 per year). Multiplying $72 times 0.50 times 18,888,888 yields the $680 million reported in the text.

[55] For example, studies indicate that one impediment to low-income and minority homeownership may be uncertainty and fear about the home buying and lending process. .See Donald S. Bradley and Peter Zorn, "Fear of Homebuying: Why Financially Able Households May Avoid Ownership," *Secondary Mortgage Markets*, 1996.

V. Tolerances on Settlement Costs

A fourth feature of the changes is to more strictly interpret the term "good faith." Currently, there is no objective accuracy standard to which originators are held when filling out the numbers on the GFE. The proposed rule contains zero tolerance for error in some categories, a 10% standard for some others, and no tolerance standard would apply (no change from the current rule) for the rest. This would reduce or eliminate surprise fees at the settlement table.

A. Zero and 10 Percent Tolerance [56]

Zero tolerance would apply to those charges that the originator should know:

- origination charges when the GFE is initially filled out;
- the interest rate dependent payment when the rate is locked;
- all third party services when selected by the lender; and
- government fees.

The rationale for zero tolerance is that any originator should know its own prices, the prices of other settlement service providers that they require borrowers to use, and the amount of taxes that will be levied on the transaction. Since they should know these numbers, there is no tolerance for error.

The **10% tolerance** would apply to required third party services selected by the borrower. In these cases, the 10% tolerance protection would be activated if the borrower asked the originator where those services could be obtained at prices covered by the tolerance. The originator could have arrangements set up for settlement services to be provided for its customers at a predetermined price, protecting the originator from prices beyond the tolerance. Alternatively, the originator could survey the market and make referrals without any arrangements with settlement service providers, but the originator would have to hope that no settlement service provider to whom it makes referrals suddenly raises prices to take advantage of the tolerances.

There would be **no tolerance** protection on homeowner's insurance, per diem interest, escrow reserves, or optional third party services. Homeowners often choose much greater hazard insurance coverage that costs more than the minimum required by lenders, so tolerances would be inappropriate. Per diem interest depends on the closing date which is not always easily predictable. Any excess in the escrow account will be returned when the first annual escrow analysis is performed. Optional third party charges are simply a matter of consumer choice.

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[56] The zero and 10 percent tolerances discussed in this section would be in effect "absent unforeseeable and extraordinary circumstances" beyond the originator's control such as acts of God, war, disaster, or any other emergency,, marking it impossible or impractical to perform. Such circumstances would have to be documented in writing by the loan originator and kept on file by the lender. Otherwise, if the cost at settlement exceeds the estimate reported on the Good Faith Estimate, the borrower may withdraw the application and receive a full refund of all loan-related fees that the borrower has paid.

Originators do not receive any of these charges except the per diem interest and that charge is the result of the interest rate on the note and the day of the billing cycle on which the loan settles.

B. Impact of Tolerances

The tolerances will lead to well informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own since the typical borrower's knowledge of the settlement service market is limited, at best. In addition to lower prices, the prices quoted are likely to be more reliable, without surprises at settlement, since the originator could retaliate by cutting off the settlement service provider who came up with these surprises. The result will be lower prices for the other settlement services. This is a transfer from other settlement service providers. The recipient is either the borrower or the lender. To the extent that the market for loans is more competitive, competition for borrowers will tend to force these savings to be passed on to borrowers. To the extent that these markets are less competitive, there will be less pressure for these benefits to be passed on. So the recipients of these transfers will be either borrowers or originators depending on the degree of competition in the mortgage market.

Tolerances should also lead to a reduction in unexpected fees at closing. Where tolerances apply, the originator must pay whatever charge is in excess of the tolerance. Origination fees, with zero tolerance, should have no surprises. Lender required and selected third parties, with zero tolerance, also should have no surprises. Lender required but borrower selected third parties should have no surprises if the borrower asks the originator where to go so that the tolerance protection applies. Originators can retaliate against any third parties who do not charge the expected prices. At the least, the offenders can be cut off from future business. The tolerances will not protect the borrower from unexpected fees in the event that the borrower buys third party services on his own.

C. Tolerances and Third Party Fees – Estimated Magnitude of Effect

The benefits from tolerances come from two sources. First is the lower prices that result from the originator arranging for the service or providing the borrower with a good benchmark from which to begin his own search. Second is the reduction or elimination of surprises at closing for any charge subject to the tolerances.

Third Party Fees. The potential savings on third party fees would come mostly from the services already ordered by the originator: appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges. In a preliminary study, HUD (2000) has published the mean value for these figures for a small sample of FHA loans originated in 1997. The average price of the first four items is $289, $64, $74, and $22 in 1997, for a total of $449 per loan, or 0.5% of the sales price. The title insurance and settlement agent charges averaged $1,134, or 1.3% of the sales price. These absolute dollar charges might be smaller than in the market as a whole since FHA home prices are lower than the average in the market. Combined, these charges come to $1,583. Considering that the survey, pest inspection, and mortgage insurance are not included (not required on all loans) $1,600 would be a conservative figure for third party charges per loan.

Using the previous projection of $1.5 trillion in loans at an average loan amount of $135,000, then there are projected to be 11,111,111 loans in 2003. At $1,600 in third party fees per loan, this comes to $17.8 billion (or approximately $18 billion) per year in total third party fees exclusive of mortgage insurance. This would be the amount subject to price pressure due to tolerances and originator shopping for third party settlement service prices.

An important question is how much of the $18.0 billion comes from small businesses. The definition of "small" for real estate brokers today is revenue of $6,000,000. We have information on title service fees for 1997. For simplicity, we will assume that the deflated value for 1997 is $5,000,000. We will use this for comparing the prices of title services in 1997. The definition of small for real estate appraisers today is revenue of $1,500,000. We will use $1,250,000 for the standard in 1997 to compare to our 1997 prices for appraisals.

The sample of FHA loans available to us has an average price of an appraisal of $289. If a firm did nothing but appraisals, then it would have to do 4,325 per year or 17 per work day to exceed the threshold for a small firm. Some appraisers are real estate agents or brokers who do appraisals to supplement their income. Since agents are independent contractors, individuals, it is unlikely that many of them who earn more than a $1,500,000 per year would do many appraisals, so most would be small businesses. A firm that does appraisals only would have to perform 4,325 appraisals or more per year to be outside the definition of small.

The average total charges for title services in the sample of FHA loans came to $1,134 in 1997. A small firm would have to close 4,409 or fewer loans to qualify as small. That comes to 17 per day. This figure should be higher because some of the title insurance premium goes to the insurance company with the commission going to the settlement agent. So these figures should be a little higher, say 5,000 settlements per year or 19 per work day. Settlements are conducted by independent settlement companies or lawyers. Law firms range in size from one lawyer to several hundred. Many settlement companies have one office but there are firms with multiple offices with a few exceeding ten offices. It would seem that most of these firms are small but with some clearly large.

With this information in hand, it is estimated that 80% of appraisals[57] and settlements[58] are performed by small businesses. There are basically three credit reporting companies in the

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[57] Data from the Small Business Administration were used for the following calculations. For 1999, the small business cutoff for small appraisers was $1.5 million in receipts. Firms with a payroll of less than 20 total employees had 76% of the employees in this industry while those with less than 100 total employees had 91% of the employees. Firms with from 20 to 99 total employees averaged 31 appraisal employees and averaged $1.276 million in payroll to these employees, implying about 36 appraisal employees to reach the $1.5 million cutoff. So small entities would appear to be between 76% and 91% of all appraisals. But this figure needs to be adjusted. The $1.5 million cutoff is for total receipts and these firms could have employees who do things other than appraisals, so the percent that are small would drop. Payroll is only part of what happens to receipts; fringe benefits, rent, supplies, owner's return, etc., need to be covered by receipts as well. This would drop the percent that are small even further. On the other hand, the statistics reported do not include individual proprietorships that may be the

country. There are basically three large tax service companies in the country the tax service companies do at least some of the flood determinations. Flood certifications, tax services, and credit reports are assumed to be done by large businesses. The result of this is that about 70% of the $18 billion, or $13 billion, in third party services is assumed to be performed by small businesses.

Origination Fees. The origination fees are also subject to tolerances, but not the originator shopping effect since the originator does not shop for his own services. According to Olson (2002), the average broker makes 2 points per loan, or $2,700 per loan at an average loan amount of $135,000. On 11,111,111 loans, this comes to $30 billion in total fees going to originators. This figure would now be subject to the limits of zero tolerance. In other words, the $30 billion would not be subject to surprise increases, above the GFE, on the HUD-1 at settlement. As discussed in Section III.D, it is estimated that small businesses account for 50 percent of this $30 billion, although the estimate is subject to variation.

VI. Trade-off of Interest Rate and Points

Originators usually offer a variety of interest rate and point combinations on any loan product. Higher points compensate for a lower interest rate and vice versa. If the rate goes high enough, the borrower can get the originator to pay some or all of the closing costs. Many originators explain this to their borrowers, giving them an array of choices to meet their needs. However, this is not always the case. Some borrowers are shown only one of the combinations, so the borrower is unaware of the potential for reductions in closing costs at higher interest rates. This inhibits their ability to shop. The YSP controversy has highlighted the importance of borrowers understanding the trade-off and its potential for covering closing costs. The new GFE is intended to ensure that the trade-off is explained to each borrower.

The proposed rule contains a provision for a new section on the GFE that shows the inverse relationship between interest rates and monthly payments on the one hand and upfront fees on the other. (See Exhibit B.) The originator would give two alternative rates for the loan

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source of many appraisals. Considering these factors, we assume that 80% of appraisals are performed by small businesses.

[58] Data from the Small Business Administration were used for the following calculations. For 1999, the small business cutoff for title, abstract, and settlement offices was $6 million in receipts. Firms with a payroll of less than 100 total employees had 68% of the employees in this industry. Firms with 100 or more total employees averaged 160 title, abstract, and settlement employees and averaged $5.775 million in payroll to these employees, implying about 166 title, abstract, and settlement employees to reach the $6 million cutoff. So small entities would appear to do more than 68% of all title, abstract, and settlement work. But this figure too needs to be adjusted. Again, the $6 million cutoff is for total receipts and these firms could have employees who do things other than title, abstract, and settlement work, so the percent that are small would drop. Payroll is only part of what happens to receipts; fringe benefits, rent, supplies, owner's return, etc., need to be covered by receipts as well. This would drop the percent who that are small even further. On the other hand, the statistics reported do not include individual proprietorships that may be the source of much of the title, abstract, and settlement work. Considering these factors, we assume that 80% of title, abstract, and settlement work is performed by small businesses.

presented on the GFE and show the impact on monthly payments and the net upfront fee. The idea is that the originator would do more than simply fill out these two examples and explain how the higher (lower) income stream resulting from the higher (lower) rate is worth more (less) in the market and how that generates yield spread premiums (discount points). The originator would go over all the options available and help the borrower compare the alternatives so that the borrower has a rational basis for making a decision about what is best for him.

In addition, so long as the borrower has had even one originator explain the relationship between the interest rate and net fees, the borrower will be aware of this and expect that any other loan offer would reflect the tradeoff. The borrower would expect that other originators would have an array of rates available and that each had associated with it a different net upfront fee that varied inversely with the rate. The basis for the existence of yield spread premiums and discount points would be better understood by the borrower, making it more likely that interest rate variations available would be used by the consumer to his advantage rather than by the originator to enhance profit at the consumer's expense.

The borrower's understanding of this relationship is important when comparing a brokered loan to one originated by a lender. The brokered loan will show any premium or discount as a pass through so that a broker cannot supplement the stated origination fee through any interest rate effects working through the price paid by the wholesale lender in the transaction: the broker must identify his fees as origination fees in order to receive compensation. Lenders may net out yield spread premiums so that their compensation as stated in the origination fee could be supplemented with a yield spread premium that is not credited to the borrower. Borrowers must understand this so that they focus on the lender origination fees subtotals when comparing loans (see Section III.C). The origination fee for a lender can be artificially low relative to a broker because the yield spread premium of a lender may be netted out of the origination fee while that of a broker may not. The lender cost subtotal cannot be artificially low relative to a broker since both kinds of originators will reflect the effect on costs of the yield spread premium by the point when the lender cost subtotal is reached.

The borrower's awareness of the trade-off is likely to be enhanced under the new rule if the borrower applies for a loan with even one broker. This results from the new provisions that require brokers to treat the yield spread premium as an explicit credit that affects the cash to close as shown on the GFE and HUD-1. This new treatment is much more likely to get the attention of the borrower than a "YSP POC" item that does not have an effect on the calculations presented. This increased awareness should lead the curious to find out where it comes from, if they do not already know, by bringing up the issue with the originator. Once this understanding is acquired, the borrower should be able to interpret the figures disclosed and effectively comparison shop regardless of whether the originator is a broker or lender.

To conclude, Section IV (on the second page) of the new GFE forces the lender to show the borrower options to the loan chosen by the borrower that is used as the basis for filling out the first page of the GFE. No longer can one option and nothing else be shown to a borrower. But the form itself seeks only to alert the borrower that options are available if none have been presented before that point. HUD expects that lenders will use more sophisticated worksheets to help borrowers decide which interest rate/fee option is best for them.

VII. Other Issues and Topics Associated with the New GFE

Timing. Another feature is that the GFE will be delivered earlier than before. While the requirement that the GFE be delivered within three days of application has not changed, the definition of application has. The definition of application is met when a property address, social security number, basic income information, borrower's information on the house price or best estimate of the value of the property, and the mortgage loan needed have been submitted by a borrower. This relaxed definition will result in applications occurring earlier in the process than before and GFEs being given out earlier as a consequence. This promotes shopping.

Prepayment Penalty. Prepayment penalties can be used to the borrower's advantage as a technique that allows a loan fee to be paid, in effect, as part of the monthly payment rather than upfront. The prepayment penalty can be used to collect the remaining unpaid part of that fee in the event that the loan is paid off earlier than expected. Sometimes, however, prepayment penalties are used for other purposes. For example, they could be designed to be a severe deterrent to paying off a loan made at a very unfavorable interest rate. The proposed disclosure is designed simply to alert the borrower that there is a prepayment penalty. If there is a prepayment penalty, the borrower certainly should be aware of it.

Splitting of Title Insurance. Title insurance prices are divided into two components. One component goes to the salesperson as a commission. The other goes to the title insurance company to cover all the other costs of running an insurance company, including making claim payments. The salesperson receiving the commission often does other settlement work as well. For example, the salesperson might be the settlement agent in the transaction. If true, the salesperson might get paid as the settlement agent and the person receiving the commission. But the commission is hidden income from the borrower's perspective. This breakout is designed to shed light on this otherwise hidden, sometimes large, sales commission often received by the settlement agent who might be charging additional fees in the transaction. It might put competitive pressure on the sum of all fees received by the title insurance salesperson.

VIII. Compliance and Other Costs

A. The New GFE Form

There are several sets of changes to the GFE that could impact costs. First, in brokered loans, the yield spread premium and discount points must equal the difference between par and the price the wholesale lender pays for the loan, and must be reported as an interest rate dependent payment that passes directly between the borrower and wholesale lender. Second, the itemization of fees is reduced with more emphasis on summary information. Third, there is a new worksheet (Section IV) that requires the originator to show alternative interest rate and upfront fee combinations. Fourth, there is an attachment A-1 that identifies required use providers and various subtotals for categories listed in Section III of the GFE. Fifth, there is the issue of re-disclosures. Lastly, tolerances are imposed on many of the estimates indicating a limit on the extent to which the borrower is responsible for actual fees that exceed the estimates.

This subsection discusses the first five changes and subsections B and C discuss some related issues with the HUD-1 and new GFE; subsection D estimates the net costs from the various effects discussed in subsections A-C. The last point (tolerances) noted above is discussed in Section VIII.E below.

(1) Under the existing scheme, originators are required to report yield spread premiums as "paid outside of closing", (POC) on the GFE and HUD-1. In order to fill out a GFE under the proposed rule, the originator must have a loan in mind for which the borrower qualifies from the information available to the originator. Pricing information is readily available to brokers, so there is no additional cost incurred in determining the interest rate dependent payment since they have to look and see if there is a yield spread premium under the current regime anyway. Since it is reasonable to assume that all brokers consult their rate sheets prior to making offers to borrowers, it is reasonable to assume that they know the difference between the wholesale price and par. It does not appear that this requirement adds any new burden.

(2) The reduction in the itemization of fees will lead to fewer unrecognizable terms on the GFE. That should lead to fewer questions about them and less time spent answering those questions. Of course, to the extent that the originator is precluded from including junk fees on the GFE, he or she will not have to spend any time trying to explain what they are. The confusion avoided may lead the borrower to better understand what is being presented so that questions on useful topics are more likely to come up and the originator can spend his time giving useful answers (or more time will be spent explaining useful things).[59] In all, the simpler GFE produces a savings in time.

(3) There is a burden to producing and explaining the worksheet in Section IV (on page 2 of the GFE) showing the alternative interest rate and upfront fee combinations. On the other hand, it might be a reflection of a worksheet the originator already uses to explain the interest rate/upfront fee tradeoff. While there may be a burden to explaining how this all works, this explanation is something all conscientious originators are already doing in the origination process. In that sense, that is no additional explanation burden arising from the production of this page. To the extent that some lenders only explain one option to a particular borrower (even though they offer others), there would be some additional costs for those lenders. Today, most originators probably present to borrowers much more complicated sets of alternative products than captured by the worksheet (remember the main purpose of the worksheet is simply to sensitize the borrower to the fact that alternative combinations of interest rates and closing costs are available).[60]

(4) Section A of Attachment A-1 (page 3 of the GFE) identifies any third party whose use is required by the originator. The new form is simpler than the old form in that the new form

[59] It should be noted that Sections I and II (on page 1of the new GFE) ask for basic information (e.g., note rate, APR, loan amount) that is readily available to the originator and thus do not involve additional costs.

[60] There is certainly no additional burden associated with Section V (also on page 2 of the GFE) which requires the lender to report basic information about loan terms (e.g., whether there is a prepayment penalty or not, type of ARM product).

eliminates the requirement to identify the relationship, if any, between the originator and the firm it is requiring. This represents a reduction in reporting burden. Section B of Attachment A-1 first breaks down origination fees into subtotals that are readily available. The subtotals for title fees should be readily available from the title agents that the originator deals with. Thus, there should be no additional burden here.

(5) If the borrower doesn't qualify for the loan presented in the originator's GFE and a new loan is offered, a new GFE must be filled out with the appropriate changes. But the borrower would be given these changes today for a new loan. The proposed rule simply requires that the new information be conveyed to the borrower through a new revised GFE.

B. New HUD-1

There is no additional burden to filling out the new HUD-1, and in fact, a possible savings. The change of reporting premiums in brokered loans as lender payments to the borrower in the 200 series is simply a substitute for reporting it "POC" in the "800" series. That implies no additional burden. There also is no additional burden to recording the borrower payment to the lender instead of discount points. This, too, is a mere substitution in terminology.

The elimination of the originator's detailed fees and junk fees on the GFE means that many of these details need not be recorded on the HUD-1 as well. The form should be easier to fill out and explain if the number of entries is reduced. The HUD-1 will still contain third-party-settlement-service-provider fees (e.g., credit report, tax service, title service). This, of course, is done today so there is no additional burden. Under packaging, this reduction in burden is magnified by the fact that so many numbers are reduced to one package fee on the HUD-1 (see Chapter 4).

C. Crosswalk Issue

There will be some burden on originatiors to explaining how the summary numbers on the GFE are related to the more detailed numbers on the HUD-1 since the two forms report the numbers differently. For example, the lender required and selected third party fees are listed as one figure on the GFE and must still be itemized on the HUD-1. They need not even be in the same series on the HUD-1. The nature of the burden will change from what it is today. Today, there may be many mismatches in the values of the numbers on the GFE and on the HUD-1 since there is no tolerance standard applied and the increased costs might require some explanation. In the future, at least the numbers with zero tolerance will have to exactly match an entry (or combination of entries) on the HUD-1, so they will be easier to match up. The entries without the zero tolerance need not be exact matches with the numbers or a sum of numbers on the new GFE. But under the new GFE there will be fewer numbers and entries in the title insurance and settlement agent areas (i.e., less proliferation of fees), thus requiring less discussion, less explanation, and less justification of fees and making the cross walk less of a problem.

D. Summary of Costs Related to the New GFE

The discussion in subsections A-C above (noting several offsetting costs effects) suggests that there will be little if any additional annual costs associated with the new GFE. Practically all of the information required on the GFE is readily available to originators, suggesting no additional costs. The fact there are fewer numbers and less itemization of individual fees suggests reduced costs. On the other hand, there will be some additional costs associated with the cross walk to the HUD-1 (and possibly a small amount of additional costs associated with the worksheet but that is not clear). Thus, while it is difficult to estimate, it appears that there could be a net of zero additional costs. If there were additional costs of say 10 additional minutes per GFE, the dollar costs would total$226 million per year.[61]

There would be a one-time cost for production of the new GFE (software development, etc.) and training of employees in its use. This one-time cost is difficult to estimate. If there were 100 software firms that each spent one person year of effort, that charge would be $15 million (assuming $150,000 per person year). If there were 36,000 firms with an average of 16 employees and each received 2 hours of training, then that would total slightly over $80 million;[62] if only one hour is required, or only half the employees required the 2-hour training, the total would be about $40 million. As noted above, it is difficult to estimate these one-time costs. The important point, of course, is that they occur only in the first year.

E. Multiple Preliminary Underwritings

Every application under the proposed rule that generates a GFE will require preliminary underwriting in order to come up with an early offer for the borrower. It is hoped that the charge for this, if any, would be small enough so that it is not a significant deterrent to effective shopping. The additional cost generated depends on the number of applicants and the number of GFEs they get. Since every completed loan eventually gets underwritten in full anyway, the additional cost of preliminary underwriting depends mainly on the number of additional times that preliminary underwriting occurs beyond the one associated with the full underwriting that would have occurred under the existing scheme. It is simply unknown how many additional GFEs the average borrower would get under the new rule. Some borrowers might shop the old fashioned way and apply only after deciding who offers the best terms. For them, the new GFE simply pins down the numbers. Others may get multiple GFEs and use them to shop. It cannot be determined how many additional GFEs and preliminary underwritings will result under the new GFE scheme.

On the other hand, there are currently 1.7 times as many applications as there are loans originated. Preliminary underwriting should decrease the number of applications that go to full underwriting. That is, in today's mortgage environment (year 2002 assumptions), full

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[61] This calculation assumes $150,000 annual salary; dividing by 2,080 hours yields about $72 per hour, or $12 for ten minutes. Assuming 19 billion applications produces a cost figure of $226 million. At 15 minutes, the cost estimate would rise to about $340 million.

[62] At $150,000, the per hour cost is $72; with 36,000 firms and an average of 16 employees, the total for a 2-hour training session would be 1,152,000 hours, which would be valued at $82.9 million. The 36,000 firms is the estimated number of mortgage originators.

underwriting is started (and probably completed) for about 19 million applications, including 8 million (19 million minus 11 million originations) that are not originated. This saving would tend to offset the increase in cost resulting from the extra preliminary underwriting noted in the above paragraph. However, it is difficult to estimate these effects.

F. Costs Due to Tolerances

Tolerances will impose some burden on originators. Since the protection of tolerances kicks in only if the borrower comes to the originator and asks where the services may be purchased within the tolerances, the originator must have reliable third party settlement service provider pricing information or risk paying what the borrower pays in excess of the tolerances. Some originators might simply check out the market prices for third party services from time to time, formulate estimates such that the several of the prices charged by the third parties fall within the tolerance, and trust that nobody to whom they refer the borrower charges a price in excess of the tolerance. Other originators might want more protection than that and have contracts or business arrangements in place that have set prices for services that are not in excess of the tolerances.

Either case requires the originator to do more than today, although even today originators fill out GFEs with estimates for third party settlement services. In the first case, the liability in the event a tolerance is exceeded would lead to at least a little more work gathering information prior to filling out the GFE. In the second case, more work would be involved in formalizing an agreement to commit the third party to a fixed price. But as noted above, originators today have to have a working knowledge of third party settlement service prices to fill out a GFE anyway. Therefore, it is only the increase in burden that would need to be accounted for here.

It is difficult to estimate these incremental costs. But to provide an order of magnitude, assume that all 36,000 firms spend an additional 10 hours arranging these services; at a cost of $72 per hour (or a $150,000 annual figure divided by 2,080 hours), this would total about $26 million. An assumption of 20 hours would yield $52 million. While it is unlikely that all firms would follow the same pattern and have the same costs (given the large variations in size), the above figures provide an order of magnitude, for the stated assumptions.

It should be noted, however, that the increased burden on any originator is likely to be much more than offset with a reduction in the aggregate shopping burden for third party providers incurred by its borrowers. The originator is highly motivated to find low third party prices. The originator could pass the savings on and make it easier to snare borrowers, or alternatively, could raise the origination fee by the savings in third party fees and earn more profit per loan. Or the final result could fall somewhere in between the two. Regardless of which path any originator chooses, the lower third party prices work to his or her advantage; originators will probably be aggressive in seeking out lower prices. The borrower benefits to the extent that, upon receipt of the GFE, he or she immediately has good pricing information on third party services. The borrower could immediately decide to use the originator's third parties, in which case his search is over. Or, the borrower could search further with the originator's prices as a good starting point and available as a fall-back, in which case the borrower's search efforts are likely to be greatly reduced. In both cases the borrower searches less. Considering the number of loans the average originator closes per year, the aggregate decrease in search efforts by borrowers is very likely to exceed the increase in aggregate search effort by the originators. For example, if it is assumed that each borrower saves an average of 15 minutes in shopping for third party services, then the total savings to borrowers would be $165 million.[63] Also, third party settlement service providers will save time as well. If half the borrower time saved comes from less time spent with third party settlement service providers, then third party settlement service providers spend 7.5 minutes less with borrowers for a saving of $170 million.[64]

G. Unforeseeable and Extraordinary Circumstances

As explained in Section IV, the proposed rule would require zero tolerance on origination fees and 10 percent tolerance on certain third party settlement fees. These tolerances would be in effect "absent unforeseeable and extraordinary circumstances" beyond the originator's control such as acts of God, war, disaster, or any other emergency, marking it impossible or impractical to perform as set forth in the agreement. Such circumstances would have to be documented in writing by the loan originator and kept on file by the lender. Otherwise, if the cost at settlement exceeds the estimate reported on the Good Faith Estimate, the borrower may withdraw the application and receive a full refund of all loan-related fees that the borrower has paid.

As defined, the "unforeseeable and extraordinary circumstances" appear as events with a very small probability. Thus, any costs associated with documenting them should be minor, particularly since any written documentation should involve information and data lenders have readily at hand. Question 2 of the proposed rule asks for comments concerning the evidence that originators would be required to produce to prove the existence of these circumstances and justify any increase in fees at settlement.

IX. Economic and Market Effects

This section pulls together many of the points that have been made above about the shopping and market effects likely associated with the new GFE.[65]

A. Improved Ability to Shop

As mentioned earlier, the new GFE will improve the ability of the consumer to shop because the presentation is simpler, the estimates on the GFEs are more reliable, the estimates will be received earlier, and in some cases they will be given at lower cost so that more loan

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[63] Calculated as follows: 18,888,888 projected mortgage applications (see Chapter 2) times $35 per hour times 0.25 hour (or 15 minutes) gives $165 million. The $35 per hour figure is based on the average income ($73,000) of mortgage borrowers during 2000, as reported by HMDA; the $73,000 income figure is divided by 2,080 hours to arrive at the hourly rate of $35. If the borrower saved 30 minutes in shopping time, then the total savings would be $330 million.

[64] Calculated as follows: $72 per hour times 0.125 hour times 18,888,888 loans yields $170 million.

[65] This section, however, is not a chapter summary. See Section I.B for a summary of the benefits and impacts of the new GFE. See the next Section X for a summary of the estimated benefits, costs, transfers, and efficiencies.

options may be compared. All of these factors make it likely that borrowers will shop more and obtain loans at lower cost leading to transfers from the originator to the borrower.

But over time as the new form is used there will be additional benefits. Those targeting the vulnerable will find fewer victims within the pool of borrowers, reducing the profitability of abusive lending. There will be a tendency for these lenders to leave the industry or become mainstream originators.

Additionally, subprime shopping will be enhanced by the ability of borrowers to compare loan offers, based on some underwriting, as given on the new GFE. Under the current scheme, good shopping data come only after underwriting is done and significant borrower expense might have been incurred. This limits comparison shopping.

The improved information available to borrowers should result in fewer badly informed borrowers in the loan market susceptible to above-market offers and abusive and predatory practices. Any originator whose prime purpose is to engage in such activities will find their efforts rewarded to a smaller extent than prior to this proposed rule since it will be harder and more costly to find victims. Other originators who engage in this activity less frequently, only when targets of opportunity present themselves, may find their hit rates falling. They may decide the business lost is not warranted by the gains from above-market offers and abusive lending. In both cases, we will see a reduction in resources used by originators to search for potential victims.

B. Competition and the Mortgage Market

One issue that underlies much of the mortgage market policy discussion is the extent to which there is competition in the mortgage market. On the industry side, there are many firms that originate mortgages and there seem to be little in the way of significant barriers to entry. The potential for successful collusion among the large number of originators is remote. With these conditions we would expect to see entry and exit until economic profit is zero: firms would earn only normal profit. So there is nothing about the structure of the industry that leads to a breakdown in competition.

On the borrower's side, there are a large number of borrowers and collusion among them is nil. But there is an asymmetry in the information in the hands of some borrowers relative to the lenders: some borrowers are poorly informed and the nature of the information gathering and application process makes some of these borrowers susceptible to noncompetitive loans.

While lenders have good information about the market for mortgages, borrowers often do not. As a result they can wind up with terms above the competitive level. This can happen under two different sets of circumstances.

First is the case where firms post prices and borrowers either take them or leave them: there is no individual haggling over terms. A borrower who does not shop and takes the first offer will either be lucky and get competitive terms or be unlucky and get a more costly loan. The borrower who shops will take the lowest terms. Even if half the lenders are noncompetitive, the borrower who shops as few as three lenders has only a 12.5% chance of getting no competitive offers (.5 to the third power). It is argued that some lower income areas have higher proportions of noncompetitive originators so that a given amount of shopping provides less protection from a noncompetitive offer.

Second is the case of non-posted prices, where each loan is the result of individual negotiation. The extent to which the originator will go in offering high terms is one important factor. The strength of the borrower's negotiation and shopping skills are also important. The unsophisticated borrower who conveys that notion to the originator and who does not shop is at greatest risk here.

Shopping is the borrower's first line defense. But shopping is more difficult for some segments of the market than others. Those borrowers who have "A" credit can shop using the newspaper, phone, internet, and other easy to access sources of information. In a short period of time, the borrower would have a sense of what competitive terms were at any point in time for "A" quality credit. The same is not true for subprime borrowers. There are many gradations of subprime credit and the borrowers are unlikely to know which standard they fit. This is especially true since different lenders would grade borrowers differently even using the same information. The only way to find out is for the borrower to go through complete underwriting. That means it is very costly in terms of money and effort for a subprime borrower to shop. That implies less shopping, which in turn implies that it is more likely that a subprime borrower will not get competitive terms for his or her quality of credit, that is, a "B" borrower may get the terms of a "B-minus" loan, or worse.

It might seem that the solution for the poorly informed is to hire a shopper to find the borrower a reasonable loan. The borrower simply pays a fee and lets a professional do the work. But this begs the question. The only way to evaluate the shopper is to evaluate the loans they get borrowers. But if the borrower could do that, they probably would not need a shopper in the first place.
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Another way for the market to break down is through misleading or fraudulent behavior. For a purchase loan, if the truth is discovered before closing, the borrower may have only two choices: take the loan or lose the house. Many would take the bad loan. In the case of a refinance, the choice is take the loan or keep the old loan. If rates have risen enough since the lock, the borrower may take the bad loan.

General strategies that are suggested by this analysis are to make it easier for borrowers to shop and to make the numbers they shop with more reliable. This is accomplished with a simpler and easier to comprehend GFE, given earlier in the process, with more reliable numbers. This proposed rule is an attempt to do just that to the maximum extent possible.

X. Summary of Benefits, Costs, Transfers, and Efficiency Gains

This section pulls together information and estimates about the benefits, costs, transfers, and efficiency gains that have been discussed. Specific quantitative estimates are provided below. As discussed throughout this chapter, it is difficult to estimate these effects, given available data. The reader is referred to earlier sections for the specific assumptions and the range of possible estimates around those reported below. Still, the estimates provide a sense of the substantial benefits of the new GFE to consumers.

Transfers: There is an estimated $6.3 billion in transfers from firms to borrowers from the improved disclosure and treatment of yield spread premiums and more and better shopping due to the improved GFE. Originators contribute $4.5 billion of this and third party settlement service providers $1.8 billion. This benefit to consumers comes from reduced overcharges that competition passes on to borrowers. It is estimated that $3.5 of the $6.3 billion comes from small businesses -- $2.2 billion from small originators and $1.3 from small settlement service providers. (See Section IV.C.)

Efficiencies: While most of the effect of this proposed rule comes in the form of transfers, many efficiencies have been discussed in this chapter. They are listed below.

(1) Borrowers will save time shopping for loans and for third party settlement service providers. If the new forms save the average applicant one hour in evaluating offers and asking originators follow-up questions, borrowers save $661 million. In addition, if borrowers save 15 minutes in shopping for required third party services, they save an additional $165 million. The total value of borrower time saved shopping for a loan and third party services comes to $826 million.

(2) Originators and third party settlement service providers will save time as well. If half the borrower time saved in (1) above comes from less time spent with originators and third party settlement service providers, then originators spend half an hour less per loan originated answering borrowers' follow-up questions and third party settlement service providers spend 7.5 minutes less with borrowers for a saving of $680 million and $170 million, respectively, for a total of $850 million.

(3) Lower prices for originators and third party settlement service providers drive out the less efficient firms with the more efficient firms surviving and doing the work. It is difficult to estimate this effect. But if the efficiency gains from loan originators come to just one percent of origination fees, firms save $300 million. This same effect would hold true for third party settlement service providers as well, resulting in a savings of $180 million. The total effect from lower prices driving out the less efficient is $480 million.

(4) The lower profitability of seeking out vulnerable borrowers for non-competitive and abusive loans should lead to a reduction in this activity. If the decline in this activity represented one percent of current originator effort, this would result in $300 million in savings to firms.

(5) There are other potential efficiencies that are anticipated from the new GFE approach but would be difficult to estimate. For example, studies indicate that one impediment to low-income and minority homeownership may be uncertainty and fear about the home buying and lending process.[66] The new GFE approach outlined in this chapter should increase the certainty

[66] See Donald S. Bradley and Peter Zorn, "Fear of Homebuying: Why Financially Able Households May Avoid Ownership," *Secondary Mortgage Markets*, 1996.

of the lending process and, over time, should reduce the fears and uncertainties expressed by low-income and minority families about purchasing a home.

Costs of GFE Form: As discussed in Section VIII, additional costs could arise from two sources.

(1) The new GFE has some features that would increase the cost of providing it and some that would decrease the cost. These might easily cancel out each other. If the new GFE added 10 minutes to the time it takes to handle the forms today, annual costs would rise by $226 million.[67]

(2) The presence of tolerances will lead to some additional costs to originators of making additional arrangements for third parties to provide settlement services. If the average firm incurred 10 additional hours spent arranging for third party services, it would come to $26 million per year, or $52 million if it took 20 additional hours.

The overall effect here is transfers of $6.3 billion to borrowers, with $4.5 billion coming from originators and $1.8 billion from third party settlement service providers.

In addition to the transfers, borrowers realize $826 million savings in time spent shopping for loans and third party services. Loan originators save $1.280 billion in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save $350 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. Some or all of the $1.280 billion and $350 million in efficiency gains have the potential to be passed through to borrowers through competition.

Costs to originators rise by $226 million if new GFEs take 10 extra minutes to fill out and by $26 to $52 million to make third party arrangements in response to tolerances.

As discussed throughout this chapter, the benefit, cost, transfer, and efficiency estimates are based on specific assumptions. Still, they provide a sense of the overall net benefits of the proposed new GFE approach to consumers.

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[67] These are annual costs. The estimated one time cost of transition is $55-$95 million (see Section VIII.D for assumptions behind this range of estimates).

APPENDIX A TO CHAPTER 3

An alternative GFE layout to the one discussed in Section III above placed the interest rate dependent payment near the bottom of the GFE after other settlement costs. There was a subtotal of total settlement costs just before the entry. The idea was that borrowers would receive this subtotal and see how much cash they needed to come up with to close, and then decide how much of the settlement costs they wanted to pay through a higher interest rate, or how much more they would pay up-front to lower the interest rate on the loan.

The rationale for this approach was that the GFE would be a worksheet that would first list and get a subtotal of settlement costs for the loan. The next number would show either how much of the settlement costs would be covered by taking a higher interest rate loan or how much higher settlement costs would be to lower the interest rate. This interest rate dependent payment would be added to the subtotal to get the total settlement costs.

One problem with this approach is that it separates the two figures that determine the loan component of the settlement costs, the origination services fee and the interest rate dependent payment. As mentioned earlier, the separation of these two numbers increases the likelihood that borrowers will make mistakes in comparison shopping, frustrating one of the important goals of this new rule.

Another problem is that this approach is not simple. Had the GFE been filled out up to the point of the interest rate dependent payment, and then a different rate selected by the borrower than the one used to fill out the form to this point, some of the numbers already filled out would have to be changed. For example, the per diem interest would change since it depends on the interest rate. Or if the borrower chose a higher loan balance to finance the closing costs, the change in the loan balance would require every number that depended on the loan amount to change. This is cumbersome.

The problem is that there is a trade-off between making the GFE a good shopping document -- simple and clear -- and a good worksheet - complicated and showing many options. A very good worksheet would probably be much too sophisticated and complicated to be a good shopping document. As a result, the first page of the GFE is designed to be a good shopping document. The second page shows two alternative interest rates and the resulting up-front costs and monthly payments so that the borrower sees on the GFE that he can trade-off the interest rate and monthly payments for up-front costs. The Department will not specify any specific worksheet that must be employed by originators. The examples are intended to provoke borrower questions on the subject if they have not otherwise been mentioned in the origination process. It will be left up to originators to decide how to explain these options to the borrower.

Another drawback would have been the separation of the two determinants of the cost of the loan as opposed to the other settlement charges. These two charges come together with the loan and cannot be separated by the borrower. They represent the loan specific effect on closing costs. For reasons discussed above, separating them would increase the chance that a borrower would misinterpret the loan component of the cost of the loan. The brokered loan presented in Table 4 is the same loan originally presented in Table 2. Remember that the other settlement costs figure that is presented here as one number is in fact several individual items covering most of the page. The placement of the $2,000 interest rate dependent payment at the bottom obscures the fact that it is a credit arising from this particular loan and must be combined with the origination fee for this loan to effectively evaluate the loan component of settlement costs.

Table 4

SETTLEMENT COSTS		
ORIGINATION FEES	$3,000	
OTHER SETTLEMENT COSTS	$4,000	
SETTLEMENT COST SUBTOTAL		$7,000
INTEREST RATE DEPENDENT PAYMENT		-2,000
DUE FROM BORROWER AT SETTLEMENT		$5,000

The lender need not show an interest rate dependent payment on his GFE. He can combine the two loan cost numbers and show the result as the origination fee. Table 5 shows a loan from a lender with the same total cost as the brokered loan in table 4, but with the net loan fees shown in the origination fee. When the interest rate dependent payment is at the bottom rather than right after the origination fee, the unsophisticated borrower is more likely to draw the erroneous conclusion that the loan with the $1,000 origination fee (Table 5) is cheaper than the loan with the $3,000 (Table 4). In this example, a lender would have the ability to raise fees almost $2,000 above the broker's fee and still appear to be cheaper to an unsophisticated borrower. With the large difference in the origination fee, some borrowers might not even bother to read down to the interest rate dependent payment.

It should be noted that the settlement cost total is unaffected by the placement of the interest rate dependent payment. It is the lender settlement cost component that is obscured by the placement of the interest rate dependent payment away from the origination fee. Placing the figures that are loan related together makes it less likely that errors will be made comparing the loan components of the charges. It must be remembered that some of the other settlement charges are still estimates and can be misleading. For example, a lender could put down low escrow deposits that the servicer can correct soon after closing or the lender could put down a unrealistic settlement date in order to reduce per diem interest. In any case, there is good reason to check the lender origination fees subtotal as well as the settlement cost total.

Table 5

SETTLEMENT COSTS		
ORIGINATION FEES	$1,000	
OTHER SETTLEMENT COSTS	$4,000	
SETTLEMENT COST SUBTOTAL		$5,000
INTEREST RATE DEPENDENT PAYMENT		0
DUE FROM BORROWER AT SETTLEMENT		$5,000

The GFE alternative rejected would have harmed the borrowers who would have paid more for their loans as a result of the confusion over comparing loan costs. The rejected alternative also would have harmed the brokers who would have lost business as a result of the competitive disadvantage introduced by the confusion over loan cost. In both cases, the beneficiaries would have been the lenders chosen as a result of the confusion.

CHAPTER 4

GUARANTEED PACKAGING

I. Introduction

This section discusses packaging or the guaranteed cost approach. Under this approach, a packager would offer a lump-sum price for settlement costs and would be held to that figure from the time the package is agreed to through settlement. This introductory section defines the concept (subsection A) and summarizes the benefits of packaging and its impacts on small and other businesses (subsection B). Then, Section II provides a more detailed discussion of the various components of packaging. Section III focuses on the impacts of packaging on borrower shopping. Sections IV examines market impacts, including the effects of packaging on the provision and pricing of settlement services. Section V examines other topics associated with packaging such as the effects of the safe harbor and caps. Section VI discusses compliance and other costs. Section VII summaries the estimates of benefits, costs, transfers, and efficiencies associated with packaging.

A. Definition of Packaging

The proposed rule would allow guaranteed packages of settlement services and mortgages to be made available to consumers; packaging would make consumer shopping easier and remove existing regulatory barriers, which are currently limiting competition among settlement service providers and causing high settlement costs.
Thus, packaging will allow market forces to reduce the costs of settlement services.[68]

The "Guaranteed Mortgage Package Agreement" would include those origination and other settlement services needed to close a mortgage, including all application, origination and underwriting services, the appraisal, pest inspection, flood review, title services and insurance, and any other lender required services except hazard insurance, per diem interest, and escrow deposits. The package would also include a guaranteed interest rate subject to change (for those borrowers that do not lock-in) only from a change in an observable and verifiable index or such other appropriate means that ensure that the any interest rate change reflects market conditions.

As explained later, the proposed rule offers a safe harbor from Section 8 for those entities providing or participating in a "Guaranteed Mortgage Package Agreement" (GMPA). The safe harbor applies an exemption from Section 8 to all consumer payments for the GMPA, as well as any payments or other things of value exchanged between entities participating in the GMPA.

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[68] For an early discussion of the benefits of packaging, see the joint HUD-Fed report, *Joint Report to the Congress Concerning Reform of the Truth and Lending Act and the Real Estate Settlement Procedures Act,* July 1998.

Section 8 would continue to apply to any payments for the referral of business, kickbacks, splits of fees and unearned fees between the packager and any of the entities participating in the package on the one hand and entities outside of the GMP on the other.[69]

B. Benefits and Impacts on Small and Other Businesses

Overview of Packaging Benefits

First, the guaranteed packaging approach simplifies the borrower's search for a loan and makes it easier to comparison shop. It includes a free interest rate quote along with one guaranteed price for most of the originator and third party fees necessary to get a loan. The items excluded are not necessarily useful for comparison shopping purposes. This basically gets the loan offer down to two numbers: the interest rate and the package price. Both are guaranteed. Second, the guaranteed packing approach would remove regulatory barriers that are today preventing market competition from reducing settlement prices. Under current law, a providers' efforts to enter into volume arrangements with settlement service firms may be regarded as illegal and restrictions against mark-ups of third party costs may impede the packaging of services. Under HUD's proposed rule, packagers will be able to enter into cost-reducing, volume-discount arrangements, and competition among packagers will pass these lower costs through to borrowers at mortgage settlement.

Estimated Impacts

While these benefits of packaging are basically similar to the benefits of the new Good Faith Estimate approach discussed in Chapter 3, it is anticipated that packaging will improve shopping and lower settlement costs to an even greater extent than the GFE approach. Chapter 3 provided some illustrative estimates of the magnitude of benefits for the new GFE approach. Under one set of assumptions, it was estimated that borrowers could save $6.3 billion in annual settlement costs. It is anticipated that a system based on packaging alone would lead to even greater savings for borrowers, as transfers from firms to borrowers will rise by $4 billion for a total of $10.3 billion. Originators contribute $6.7 billion of this and third party settlement service providers, $3.6 billion. This benefit to consumers comes from further reductions in overcharges that competition passes on to borrowers. Under this scenario, the final savings to the borrower would depend on how the market settles down between the two methods of loan origination – the new GFE approach and packaging. If it is half and half, borrower gains are slightly over $8 billion.

In addition to the transfers, there are several efficiencies associated with packaging (see the summary in Section VII). Borrowers realize $1.652 billion savings in time spent shopping for loans and third party services. Loan originators save $2.710 billion in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save $700 million in time spent with shoppers and from the substitution of more efficient for less efficient third

[69] The safe harbor exemption is available only where the origination does not result in a high cost loan as that term is defined in the Homeownership Equity Protection Act. See Section V.B below.

party settlement service providers. Some or all of the $2.710 billion and $700 million in efficiency gains have the potential to be passed through to borrowers through competition.

The simplification and other advantages of the new GMPA will lead to lower costs than under the new GFE. It is assumed that costs under the GMPA will be the same as today's GFE. As discussed in Section VI, one area of uncertainty about packaging and the new GMPA concerns the index that is used to ensure that changes in the interest (note) rate reflect changes in the market. Until the exact mechanism is selected, it is difficult to determine the effect of the index on packaging.

Concerns have been expressed about the impacts of the packaging approach on small lenders and small service providers. This chapter estimates that small businesses (i.e., small originators and small service providers) would account for $5.9 billion of the $10.3 billion in transfers. The effects on small businesses are also discussed below and throughout this chapter.

The **specific benefits and impacts of packaging** are as follows:

Shopping Benefits

- Guaranteed packaging will improve and increase borrower shopping for mortgages. Basically, guaranteed packaging reduces the loan offer to two numbers (a settlement package price and an interest rate), has zero tolerance on the package price, and guarantees the interest rate if locked (otherwise the rate varies with a market index). In addition, the offer is free and, if agreed upon by the borrower, the offer becomes a contract that is enforceable. These are all advantages over today's process of shopping for mortgages, as well as over the Good Faith Estimate approach outlined in Chapter 3.

- The simplified loan offer under packaging does away with the proliferation of fees, including junk fees that often characterizes today's mortgage offers.

- The packaging agreement eliminates the separate reporting of the premium or discount associated with brokered loans. This is done to facilitate competition and comparison shopping.

- Economic efficiencies result from easier and less time consuming shopping under packaging. Borrowers are better informed, shop better, and reach better deals.

- In this case, the main transfers will be from originators who are charging above market prices to borrowers who are more informed and better able to comparison shop (see the $6.7 billion estimate reported above).

Lower Settlement Service Prices

- The Section 8 safe harbor will allow greatest protection to entities within the package from charges of illegal referral fees, kickbacks, and unearned fees. This will free up packagers to pursue lower prices for third party services in their package without concern that the technique used could be a Section 8 violation. Competition is substituted for regulation.

- Thus, packaging will result in lower prices paid for settlement services, as packagers aggressively seek discounts in third-party service prices. A better shopper (the packager) is substituted for the borrower as the searcher for third party settlement services.

- In addition, there are several efficiencies associated with packaging that could lead to lower costs. Under packaging, originators may deal with one packager, rather than a whole array of third party providers and the packager, who specializes in this activity, may be more efficient than the originator.

- Given the likelihood that there will be competition among a number of packagers, the lower third party service prices will be passed through to borrowers as lower costs for closing a loan. In this case, the main transfers will be from settlement service providers to borrowers (see the $3.6 billion estimate reported above).

Impact on Business Operations and Market Structure

- The proposed RESPA rule offers a dual approach to settlement market problems – (1) a new, simplified GFE combining tolerances on final settlement costs and a new method for reporting wholesale lender payments; and (2) a guaranteed cost approach based on packaging. Consumers and originators can use either approach, which has the advantage of allowing the market determine the best approach under a given set of circumstances. While there are reasons to expect originators to move toward the packaging approach, it is difficult to estimate the share of the market that will ultimately fall under packaging, as well as the timing of the move toward packaging.

- An uncertainty with respect to the implementation of packaging concerns the interest rate index that determines changes in mortgage rates for borrowers who are shopping (before they sign the guaranteed packaging offer) and for borrowers who choose to "float" rather than "lock-in" their interest rate (at the time they sign the offer). Packaging depends on lenders finding an acceptable interest rate index, or some other mechanism for ensuring that any changes in the interest rate reflect overall market changes. As noted below, there will likely be some costs associated with lenders' guaranteeing that interest rates move only with market conditions, depending on the indexing technique chosen.

- As explained in this chapter, packaging could take several forms – for example, originators could develop their own packages or specialized firms could develop packages, or components of packages, which they would then sell them to originators. The section on small business below highlights several additional market impacts of packaging.

Compliance and Other Costs

- The GMPA and HUD-1 with packaging will have substantially fewer numbers and less detail than the current GFE and HUD-1. Only six numbers are required on the first page of the Guaranteed Mortgage Packaging Agreement. This will lead to a more efficient origination process since less time will be spent by the originator and the borrower in deciphering the proliferation of fees that now characterizes the GFE and HUD-1.

- Packaging eliminates the reporting of individual fees within the package and in so doing permits, in effect, average cost pricing. This reduces costs because firms do not have to keep up with an itemized, customized cost for each borrower.

- As mentioned above, there could be some additional costs associated with lenders having to use an as yet undetermined index in order to guarantee market interest rates (a) during the time that the consumer is shopping (after the packager has made the offer) and (b) during the time between the offer being accepted and final closing for those borrowers who choose to "float" rather than "lock-in" their interest rate. The proposed rule asks for comments on how the interest rate index could be determined.

- Originators make a free offer that is also guaranteed. This will require additional information gathering and preliminary underwriting to the extent that borrowers seek multiple offers, beyond what they do in today's market. There could also develop some degree of uncertainty and costs associated with originator's making guaranteed offers based on preliminary underwriting, particularly for those borrowers who typically require extensive underwriting. As explained in Section VI, however, this would simply result in the originator making a new loan offer or sending their customer elsewhere.

- There will be some costs associated with the arrangements that packagers have to make with third party settlement service providers, in order for the packager to ensure that there would be no change in the pre-arranged third party prices. But as discussed in Section VI, other efficiencies resulting from packagers dealing with third party providers are expected to offset these costs.

Summary of Small Business Impacts and Alternatives Considered

As noted above, concern has been expressed about the market impacts of packaging, particularly as they relate to small businesses. The main findings regarding the effects on small businesses are as follows:

- The nature of locally-provided, third party services (such as appraisal, survey, pest inspection, closing agents) could remain the same under packaging – the main change will involve who purchases these services. As noted above, packagers will be the new purchasers of these services, and third party service prices will be lower.

- Under packaging, those third party service providers (both large and small) who are currently charging high prices for their settlement services would experience reductions in the prices of their services. To the extent that third party settlement service providers happen to be small businesses, they would, of course, experience a reduction in their revenues. Of the $3.6 billion in price reductions for third party services, the small business share is $2.5 billion.

- It is estimated that small businesses (i.e., small originators and small service providers) would account for $5.9 billion of the $10.3 billion in transfers to consumers noted above -- $3.4 billion of this would come from small originators and $2.5 billion would come from small settlement service providers. As in the case with the new GFE approach, firms suffering losers under packaging are originators and third party providers who are currently charging high prices for their services.

- Still, there is no strong reason to expect that locally-based small businesses could not continue providing third party settlement services under packaging, albeit at possibly lower prices and revenues, as noted above. Services that are local in nature (such as appraisals) will continue to be demanded under the packaging approach. Services that are national in nature and characterized by economies of scale (such as credit reporting) are already being conducted by larger firms on a national scale.

- There has also been a concern that small lenders would be placed at a disadvantage under packaging because of the "bulk" buying power of large lenders. While this may be the case, it does not have to be. First, there is no evidence of this effect today where large lenders can purchase services such as appraisals on a "bulk" basis. Second, if specialized packaging firms develop, it seems reasonable to expect them to offer their packages to small lenders as well as large lenders. It is difficult to reach firm conclusions about the magnitude of the impact on small lenders.

- Brokers, most of whom are small businesses, could pursue a number of avenues under packaging. They could develop their own package, purchase one from specialized firms, or use the package offered by the wholesale lender they are dealing with. Under packaging, brokers will continue their main function of reaching the consumer, just as they do today. This customer outreach function is not going to go away with packaging.

- Furthermore, Chapter 2 of this Economic Analysis reports that technology improvements and other recent changes in the mortgage market have probably increased the competitive position of brokers relative to other originators. These underlying strengths of brokers are also not going to disappear with packaging.

Section IV.D discusses alternative policies that were considered. The Department considered writing this proposed rule as if only lenders could package. This idea was rejected in favor of allowing anyone to package so long as the package contains a loan. This further affords smaller firms the opportunity to offer their services and benefit from a packaging environment.

Under packaging, there is no separate treatment of premiums or discounts and no special rules for brokers. Thus, all originators present their loans the same way and all the market's competitive forces are applied to everything in the package regardless of the type of originator. No broker, or any other kind of originator for that matter, is at a competitive disadvantage. (See Section IV.D.)

II. Guaranteed Packaging: Rationale and Main Components

A. Rationale for Packaging: Current Regulatory Barriers

There are two major problems with the current settlement process that packaging has the potential to address. First, current RESPA regulations have led to a proliferation of charges and junk fees that makes consumer shopping and the mortgage settlement process both difficult and confusing, even among the most informed shoppers. The shopping advantages of packaging were noted above and will be explained further below.

Second, current RESPA regulations are acting as a major barrier to competition and are thus keeping settlement costs high. Today's mortgage market is characterized by increased efficiencies and lower prices along a number of dimensions -- automated mortgage scoring systems are shortening the underwriting process and leading to more fine-tuned credit risk determinations; automated valuation models are being used to reduce the price of appraisals for certain types of properties; and, as explained in Chapter 2, brokers and other originators are driving down the time and costs of the mortgage lending process. According to industry representatives, the one area where efficiencies and competition are being held back is the production and pricing of settlement services.

Specifically, proponents of packaging assert that HUD's RESPA rules impede arrangements for the packaging of settlement services. They point out that Section 8 effectively prohibits volume-based discounts between settlement service providers since such arrangements may be considered compensated referral arrangements in violation of the statute.[70] Packaging proponents also argue that it would be much simpler for lenders to charge the average cost of a service to each borrower, which would eliminate costly record keeping on a per loan basis. Under today's rules, lenders can not use average cost pricing because questions might arise whether (say) a borrower who needed only the low cost credit report should have the same price as one with a high cost credit report.

Proponents of packaging assert that because of Section 8's prohibitions and questions about how they apply, lenders and others do not package. These proponents say that a Section 8 safe harbor is needed before packaging will take place.

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[70] In addition, RESPA prohibits requiring the use of an affiliated settlement service provider except in limited circumstances, which can be an impediment to packaging services. Under Section 8(c)(4) of RESPA an entity may refer business to an affiliate as long as the affiliate arrangement is disclosed, there is no required use and the only return is a return on capital.

As stated in the proposed rule, HUD has concluded that deregulation and increased competition may more effectively lower costs than the current restrictions and, for this reason, the establishment of a Section 8 safe harbor is warranted for those who offer a guaranteed cost package (as defined below). Moreover, under HUD's proposal, settlement service providers may choose either to operate under an improved GFE regimen (see Chapter 3) or to fall within the safe harbor. Accordingly, this dual scheme will provide industry and consumers with an opportunity to test both methodologies where they should be tested, in the marketplace, to determine which is more effective in lowering settlement costs.

B. Main Components of Packaging

The proposed rule has an alternative to the Good Faith Estimate disclosure approach. It is a guaranteed package agreement for the borrower. The package would combine several components of settlement costs on the GFE into one number on the agreement that would be guaranteed not to change. The interest rate would be included in the package either as a locked rate or one that would vary according to the market[71], depending on the borrower's preference. The form on which this is delivered is in effect a simplified GFE, but it is also a contract offer that, if accepted by the borrower, becomes a binding contract. (The first page of the "Guaranteed Mortgage Packaging Agreement" is presented in Exhibit C.) Finally, the lender may impose no charges on the borrower prior to the delivery of the guaranteed packaging agreement offer.

In exchange for providing the guaranteed package, the packager would be provided with a safe harbor under Section 8 for the package and everything within it. Of course, the packager would have to make the arrangements for all of the services provided within the package.

The guaranteed package price includes origination fees, interest rate dependent payment, settlement fees lender's title insurance, all third party fees, and government fees.[72] The guaranteed package price has a zero tolerance applied to it so that there can be no surprises associated with it at all. The only fees outside the package are for the establishment of the escrow account, the per diem interest, homeowner's insurance, and borrower's title insurance.

The package includes an interest rate for the loan. When the package is offered, the borrower may accept immediately. If so, the borrower may lock the interest rate offered or choose to let it float according to a market index, which is as yet unidentified (the proposed rule

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[71] As explained in HUD's proposed rule, the market index is undetermined. There is no available interest rate series that has been accepted by the industry to serve as this index of how the market moves. See Section VI for further discussion of the interest rate index.

[72] There are items outside the package and the borrower must be treat them with care when comparing loan offers. Homeowners insurance is a function of the insurance company the borrower chooses and the coverage options elected. It is likely to be the same for any loan the borrower chooses. The per diem interest depends on the day of the month of closing: the daily charge would be different among loans only to the extent that the loan balances or the interest rates on the loans differed. For most borrowers, these differences are likely to be small. The escrow deposits belong to the borrower and overcharges would be returned at time of the first annual analysis. While cushions can vary according to the servicers policy, they can also change with no warning upon sale of the servicing, and the borrower cannot know to whom the servicing rights might be sold. Borrower's title insurance might be determined by state law. The borrower should check to see if this varies according to originator.

asks for comments on how this index would be determined). If the borrower chooses not to accept at first, the rate may vary according to the index. If the borrower chooses to accept the offer later, the rate may be locked at that time or allowed to float according to the index. The index is also used as the basis for varying interest rates during the shopping phase, after the packager signs the offer but prior to the shopper accepting it.

The guaranteed packaging agreement offer and form must be delivered before any fee can be charged to the borrower. If substantial fees were charged for the offer, it would be prohibitively costly to the borrower to use the offer as a shopping device. Such fees are prohibited in order to promote the use of the guaranteed packaging forms for shopping purposes.

Finally, the guaranteed packaging form is a contract offer that may be accepted by the borrower as a contract enforceable by state law. Currently, RESPA offers little useful enforcement options for borrowers whose charges at settlement vary substantially from the GFE. The contract, however, gives the borrower the protections of state contract law. Even though the cost of taking an originator to court may be a deterrent to the borrower filing a suit, that possibility may serve as an incentive to the originator to abide by the contract. In any event, it gives the borrower an additional tool to enforce the terms of the deal.

III. Packaging: Discussion of Borrower Shopping Benefits and Impacts

This section discusses the potential benefits of guaranteed cost packaging for borrower shopping. Emphasis is placed here on improved shopping due to the simplicity and certainty of the guaranteed package offer. The additional benefits to borrowers from price reductions due to increase competition among settlement service providers are discussed in Section IV.

A. Improvement in Borrower Shopping

The guaranteed package simplifies the loan process for the borrower. The borrower is relieved of the burden of arranging for third party services such as a settlement agent and title insurance, a survey, or a pest inspection. Under packaging, these would be arranged by the originator, as is the case under the current regime for the appraisal, credit report, tax service, flood certificate, and mortgage insurance.

Packaging also simplifies the process of comparing loan offers. Many categories of fees are combined into one fee, the guaranteed package price. The premise underpinning packaging is that firm, simple, guaranteed price quotes will enable borrowers to shop for mortgage loans with much greater confidence and certainty. Under packaging, borrowers will shop among packages, rather than separately for the individual settlement services comprising a package; the Guaranteed Mortgage Packaging Agreement (Exhibit C) does not itemize the individual costs of the proliferation of settlement services -- one lump sum cost is provided.

There is a zero tolerance applied to that figure, so it cannot change, which will increase certainty of the process for shoppers. The interest rate can vary, but only according to an observable index, so that the borrower can monitor, for any offer, how the interest rate offer changes over time. This simplifies and pins down the fees. For shopping purposes, the loan offer is basically reduced to two numbers that reflect the cost of the loan.[73] The package price never changes and the interest rate changes can be monitored at any point in time.

The effect of offering a package of services at a fixed price and an interest rate that varies according to the market makes it simpler for the borrower to shop for loan terms. The package price is fixed and the closing costs outside the package cannot vary to the originator's advantage. The borrower can get several offers at different points in time. These offers will be much easier to compare than today's more complicated and non-guaranteed offers. The package price for each loan remains the same and the borrower can check how the charge that can vary, the interest rate, has changed since the time of the offer. When the borrower decides on a lender, there will be no surprises with respect to the package price since there is zero tolerance on that figure. And the interest rate will have changed only according to an observable index that is a reflection of the market.

In addition to making comparison shopping simpler, the cost of shopping is held to a minimum by the prohibition against originators charging fees prior to the guaranteed package contract offer being delivered. The cost to the borrower of taking the time to apply for the loans is still present. But the potential charges by the originator (application fee or appraisal) have been eliminated. If these were present, the cost of applying would make using these forms for comparison shopping purposes prohibitively expensive. With fees eliminated, the only cost remaining is the value of the time spent in the application and comparison process. That is unavoidable.

Finally, the fact that this is a contract increases the likelihood that the numbers will be honored at the settlement. The combined result is that the guaranteed package approach makes comparison shopping simpler and less costly for borrowers while delivering more reliable results. Anytime the cost of an activity goes down, consumers will engage in more of it. The end result should be an increase in comparison shopping by borrowers.

Another source of increased efficiency is the reduction in effort required to analyze and compare loan offers under packaging. Since the presentation of the up front costs is simplified, it takes less time and effort to analyze that component. Both analyzing a specific loan offer is simpler than they would be otherwise. Comparison shopping is simply the comparison of the important terms of several loan offers. Since the analysis is easier, comparison shopping is easier and the resources consumed by the borrower who shops is reduced.

B. Factors Affecting Increased Borrower Shopping

The effect on individual borrowers depends on the extent to which the borrower engages in increased effective shopping in the market. Currently, we would expect that those who shop more tend to get more competitive terms those who do not. While we would expect that any increase in shopping could only improve the outcome for the borrower, the room for improvement is greater among those who currently shop less. So the final outcome for any individual borrower under the proposed rule depends on two things. First is their potential to get

[73] See above footnote for items that are outside the package.

better terms: those with the worst terms have the most room to improve. These could be uninformed borrowers who are currently being taken advantage of by lenders' high pressure sales pitches or creditworthy borrowers who are paying high interest rates in the subprime market.[74] Second is the borrower's increase in shopping efforts: the greater the increase, the greater the gain for them. The greatest gains would be expected for those who used to shop the least and who increase their shopping efforts the most. It is anticipated that shopping would particularly increase over time as consumers become familiar with using the simple form and HUD and others publicize the shopping advantages of the form.

C. Secondary Impact of Increased Shopping

The increase in shopping should lead to better loan terms for borrowers. The decreased likelihood of an originator finding a borrower who will accept costly loan terms should lead to a decrease in the profitability of originators searching for such borrowers. Anytime an activity gets less profitable, fewer resources will be devoted to that activity. This could manifest itself in two ways: fewer firms specifically designed to find such borrowers and fewer individual originators with other firms willing to expend their individual resources searching for them.

This has two consequences. In addition to the benefits accruing to themselves of those who engage in increased search efforts, other borrowers will benefit due to the decreased probability of the non-shoppers finding an originator who exploits their ignorance of the market. These other borrowers will have a higher probability of getting better loan terms than before. In addition, efficiency will increase to the extent that fewer originator resources will be expended in this effort to exploit borrower ignorance.

D. Reduction in Borrower Shopping for Settlement Services

As explained in Section IV below, the market for settlement services should change as well. The borrower will be shopping for fewer settlement service providers and loan originators will be doing the shopping instead. Currently, the borrower typically purchases these services once every several years at most. He or she is certainly not an expert at making these relatively infrequent purchases.

The packager is likely to behave much differently from the average borrower. First, the packager will be making a large purchase relative to the borrower. While the average borrower buys one set of settlement services every several years, even a small packager would be buying 50 to 100 sets per year. The higher frequency of purchase gives the packager a much larger incentive to search out lower prices than the individual borrower. Second, the packager is likely to be much more knowledgeable with the market for the third party services than would be the average borrower. Thus, the packager has the incentive to strike hard bargains and the expertise to operate effectively in that market.

Therefore, one source of increased efficiency would be the substitution of the packager as the shopper for third party services for the borrower. The packager would engage in one search

[74] In an analysis of the 1998 Survey of Consumer Finance, Getter (2002) found that prime (i.e., less risky) borrowers who were paying high interest rates were also the borrowers who said they did not engage in much shopping.

for these services while the borrower would have had to do this for each loan otherwise. The packager would probably spend more resources on its one search than would an individual borrower, but the aggregate resources that would have been used by all the borrowers who use the services of the packager would probably far exceed what the packager uses on the one search. Thus, the aggregate cost of the search for third party services would drop under packaging.

E. Estimated Borrower Savings

In Chapter 3, it was estimated that the new GFE approach will result in borrowers saving $6.3 billion in settlement costs, under one illustrative scenario with its set of specific assumptions. Improved disclosure and treatment of yield spread premiums and more and better shopping due to an improved GFE should lead to these borrower savings, which represent transfers from high cost originators and third party settlement service providers. To provide a sense of the magnitude of the savings under packaging, that scenario is extended here. It is estimated that the effect of packaging will save borrowers another 10% of the unreturned $7.5 billion in yield spread premiums (YSPs), another 10% of the $18 billion in third party fees,[75] and another 10% of the $15 billion in origination fees aside from YSPs. This comes to an additional savings of $4 billion in settlement fees or $10.3 billion if all originators use packaging. This is an overall savings of 21% of the total fees ($48 billion) included in these calculations: origination services including yield spread premiums, appraisal, credit report, tax service, flood certificate, and title and settlement charges. It should be noted that the above assumes all loans are processed under packaging (see below).

The overall effect here is transfers of $10.3 billion to borrowers, with $6.7 billion coming from originators and $3.6 billion from third party settlement service providers. Using assumptions developed in Chapter 3, it is estimated that small businesses would account for $3.4 billion of the $6.7 billion in transfers from originators, and for $2.5 billion of the $3.6 billion from settlement service providers.[76]

The outcome between the $6.3 billion in transfers to the borrower under the new GFE and the $10.3 billion under packaging depends on the how the market settles down between the two methods of loan origination. If it is half and half, transfers to the borrower from originators and third party firms are $8.3 billion.

The reader is referred back to Chapter 3 for the assumptions underlying these estimates of transfers. As noted there, while the analysis depends over numerous assumptions, it does illustrate the magnitude of the benefits to the consumer that can be obtained when reforming the mortgage process.

[75] The reduction in settlement service prices is discussed below in Section IV.D.

[76] Section III.D of Chapter 3 estimates that small businesses would account for one-half of the originator effects while Section V.C of that chapter estimates that small businesses would account for 70 percent of the third party effects.

The remainder of this chapter also discusses various efficiencies associated with packaging. Borrowers realize $1.652 billion savings in time spent shopping for loans and third party services. Loan originators save $2.710 billion in time spent with shoppers, efforts spent seeking out vulnerable borrowers, the substitution of more efficient for less efficient originators, less time spent filling out the GMPA, and simpler record-keeping. Third party settlement service providers save $700 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. See Section VII below for a summary of all the benefits and efficiencies associated with packaging.

IV. Packaging: Industry Structure, Price Effects, and Industry Impacts

This section examines the likely impacts of packaging on market structure, market competition, the price of settlement services, and industry actors. An underlying theme of this section is that packaging could take several forms with varying impacts on market structure; however, regardless of its impact on market structure, significant reductions in closing costs are expected and competition among originators and packagers is expected to pass these cost reductions to consumers. The section also discusses concerns that have arisen about the impact of packaging on small businesses.

A. The Nature of Packages

In order to be eligible for the packaging safe harbor, the borrower must be presented with a guaranteed interest rate and a package fee that includes all the payments necessary to get a loan with the exception of homeowner's insurance, per diem interest, and escrow deposits. Any entity may offer the borrower a package that includes the required components. And the manner in which the package is assembled is not specified in the proposed rule.

The assembler of the third party services that must be included in the package may be any entity, originator or otherwise. Today, the originator already arranges for several of the services necessary to get a loan, e.g., appraisal, credit report, tax service, flood certificate, and mortgage insurance. It would not be surprising to see the originator assembling the rest of the third party services needed to get a loan, for example, the settlement agent and title insurance, survey, or pest report. But that need not be the case.

It could be that firms arise that specialize in assembling third party services to market to originators. This intermediary would determine quality standards for the third party services and negotiate prices. This collection of services would then be offered to the originator for a price.[77] The originator would buy a package of third party services rather than assemble the package

[77] There might be a decrease in resources consumed in marketing by the third party settlement service providers who move into packaging. The marketing efforts of these specialists might be redirected to the packagers rather than to individual borrowers. The number of packagers would probably be a small fraction of the number of individual borrowers who use packages. Even though the third party settlement service provider sales effort per packager would certainly exceed the sales effort per individual borrower, the fact that there are far fewer packagers than borrowers might lead to a decrease in the sales effort resources expended on a per basis.

itself. In fact, the originator might arrange some of the third party services itself and buy the remainder of the third party services it needs from a sub-packager or sub-packagers. It is not at all obvious how this will play out over time.
The likely nature that packaging will take is discussed further in Section IV.D below, which examines the impact on small service providers.

B. Competitive and Price Effects of Purchasing Settlement Services Under Packaging

Packaging should create more competitive pressure on the market for settlement services. This should result from the substitution of an expert shopper (i.e., the packager) for the borrower who certainly does not have the same degree of expertise. Even in the area where the originator used to select third party settlement service providers anyway, the Section 8 safe harbor should make originators more aggressive in seeking out lower prices. In either case, the result should be increased competition with pressure for prices for settlement services to fall. This increased competition and aggressive search for lower settlement service prices are major anticipated benefits of packaging.

Any drop in the prices of settlement services that results from packaging will result in transfers from settlement service providers whose prices have dropped to the packagers. To examine the ultimate price effect on borrowers, it is useful to consider three ways that packagers might sell their services: (1) the packager is the originator, (2) the packager is an independent firm that sells a package to an originator, and (3) the packager is an independent firm that markets itself to borrowers who then find an originator who will agree to be matched up with the package.

1. If the packager is a loan originator, the extent to which the price cuts are passed on to the borrower depends on the extent to which the origination market is competitive. The industry is characterized by many firms and there seems to be no significant barriers to entry. The recent growth of brokers demonstrates this. Even large firms are subject to intense competition in the mortgage market. Successful collusion would seem very unlikely with the large number of originators in the market. So on the industry side, entry would be expected to work against persistent economic profit. If costs were to systematically to fall, competition among firms would be likely to drive prices down. The decrease in costs would reflect itself in lower prices to borrowers.

2. If the packager is an independent firm that sells a package to an originator, then the extent to which the price decreases are passed on to the originator depends on the extent to which the market for packages sold to originators is competitive. There would seem to be many buyers for such a good. There is no reason to believe that the packaging industry would not be competitive. Thus, it seems reasonable to expect much of this transfer to pass from packager to originator. And, as mentioned above, market forces will create pressure for the transfer to be passed on to borrowers.

3. The third case is where the packager is an independent firm that markets itself to borrowers who then find an originator who will agree to be matched up with the package. To the extent that there are no barriers to entry in the packaging industry, we would expect entry until economic profit equals zero. That means that the price drops would be passed on to borrowers. But if some borrowers operate better in markets than others, the pass through will be uneven, with those who are not skilled at shopping to get less and those with good shopping skills getting more. So while the transfer would be passed to consumers, the effect would be uneven.

So in all three cases, the results of packaging will be competitive pressure for transfers from settlement service providers with additional competitive pressure for these eventually to flow to borrowers.

C. Effect on Small Originators and Brokers

Some argue that small originators will be at a disadvantage relative to large lenders under packaging. They argue that the greater buying power of the larger originator makes it easier for the larger originator to get lower prices for the third party services in his package than a small originator could in his package. That is, large originators have an advantage over the small originators due to their bulk buying power. But that assumes that the originator will form the package of third party services. It might be that independent firms would come into existence for the purpose of assembling and selling these packages of third party services to small originators. They would be large purchasers of the third party services as would be a large originator who assembled its own package. If this market for packages of third party services were competitive, and there is no reason to believe it would not be, then the small originators would not be at a disadvantage relative to the large originators.[78]

Brokers, many of whom are small originators, have thrived in recent years. As discussed in Chapter 2, they originated few loans in the late 1970's but now originate over half of all mortgage originations. Clearly, they have no problem competing with in today's market. Brokers could pursue several options with respect to packaging – assembling their own packages, purchases packages from specialized packaging firms (see above), or using packages developed by the wholesale lender with which they are doing business. It is also important to note that the main function of brokers is to attract and bring mortgage customers to the table. This customer outreach function is not going to change with packaging. Furthermore, Chapter 2 reported that technology improvements and other recent changes in the mortgage market has probably increased the competitive position of brokers relative to other originators. These underlying strengths of brokers are not going to disappear with packaging.

Alternatives Considered. The Department considered writing this proposed rule as if only lenders could package. This idea was rejected in favor of allowing anyone to package so long as the package contains a loan. Thus, lenders, real estate brokers, appraisers, settlement agents, or literally anyone else may form the package and be eligible for the safe harbor for which it qualifies. No one, large or small, is favored by any artificial restriction. Furthermore,

[78] In addition, we are not aware of any evidence today that suggests that small originators pay higher prices for the third party services that they (rather than the borrower) order, e.g., appraisals, tax services, or flood certificates.

sub-packages may be formed and sold to full-fledged packagers. This is permissible since the sub-packager is within the package. This further affords smaller firms to offer their services and benefit from a packaging environment.

Under packaging, there is no separate treatment of yield spread premiums or discounts and no special rules for brokers. Competition is thought to be an adequate substitute for regulation in the packaging option. The simplicity of getting so many otherwise itemized costs in one figure that would be subject to all the borrower's shopping and competitive efforts is thought to justify lumping the premium or discount into the guaranteed price. Thus, all originators present their loans the same way and all the market's competitive forces are applied to everything in the package regardless of the type of originator. No broker, or any other kind of originator for that matter, is at a competitive disadvantage.

D. Effect on Settlement Service Providers

Some have voiced the concern that small settlement service providers will be forced out of the market under packaging and that the industry will be characterized by a few large national firms. It is not obvious that this must be the result.

Currently, originators usually order appraisals, credit reports, tax services, flood certificates, and private mortgage insurance. The latter four items are sold by large, national firms. The nature of these products must lead to large economies of scale and thus these services do not require a local presence in order to be provided. There is no advantage derived from the presence of an employee of a credit reporting company when delivering a credit report. The same is true for the services of a tax service or a firm that issues flood certificates.

But an appraiser must be present in order to do a full home appraisal. While the firms that deliver credit reports, tax services, and flood certificates are large national firms, the appraisal industry still has a large number of small firms. It might be that the local presence necessary to perform the service well is the reason for this. While automated appraisals may increase in the future, that would not seem to depend whether packaging were adopted or not. Those originators who still want a traditional appraisal will have to order it from a firm with a local presence. There are still large numbers of such local appraisal firms in existence today despite the fact that there are many large originators in the market and those originators determine who does their appraisals.

The other three settlement services that might be affected by packaging are settlement agents, surveyors, and pest inspectors. In the market today, some originators have gone to using notaries to get settlement papers signed in lieu of the traditional settlement process. Again, that development has occurred in the absence of packaging and may be a trend. But packagers who want local settlement agents may well simply hire those firms like those who do settlements today without the advent of large national settlement firms. It might end up like appraisal industry today. There may be no substantial economies of scale for some settlement services. Even if there were, it is hard to imagine how packaging would affect the situation.

Clearly surveyors must show up locally to do their jobs. They would seem to be most like appraisers. While there are national pest inspection firms, there are also local firms who do this work. Given the large national nature of some originators in today's market, it is worth noting that surveyors, settlement agents, and to some extent pest inspectors are still characterized by local firms. There might be something about the local provision of these services at the time of origination that prevents economies of scale that could be exploited by large national firms. In any event, there is nothing about the provision of these services that would change under packaging.

While the provision of these services will not change, the buyer of the service will change to the extent that packaging takes hold. The packager will substitute for the originator or the borrower depending on who selected the settlement service provider prior to packaging. But whether that packager is a local firm or a large national firm does not change the nature of the work. For example, the surveyor will still go to the property and identify its boundaries regardless of the name of the person who pays him.

If competition under packaging drives down prices, it is the less efficient who will be driven out of the market, not necessarily small businesses. The small have survived in appraisal despite the fact that it is originator rather than the individual borrower (the relatively large rather than the relatively small) who does the selection. As noted above, there is no reason to believe the small firms cannot survive in pest inspection, surveying, and in the settlement agent industry. But under packaging, those third party service providers (both large and small) who are currently charging high prices for their settlement services would experience reductions in the prices of their services.

To the extent that third party settlement service providers happen to be small businesses, they would, of course, experience a reduction in their revenues (see Section III.C). But the purpose of RESPA is to eliminate unnecessarily high settlement costs through competition. If prices fall to competitive levels, then the changes brought about are exactly what RESPA was designed to do, regardless of whether the firm receiving the lower prices is small or large.

E. Effect of Giving Guaranteed Packaging Agreement Offer Free

The loan offer must be given at no cost. The purpose of this is to prevent upfront fees that discourage shopping. But anytime a buyer faces less than the full cost of an activity, consumption of that activity is likely to be greater than what is optimal. So there is likely to be over searching for loans. It should be noted, however, that borrowers still face all of their non-pecuniary costs of applying, which are not trivial, so that applicants still face costs that tend to put a limit on borrower search.

The impact on firms will vary. Firms that take applications in person may have to devote significant time in taking in information and explaining loan product options as well as the up-front fee/interest rate trade-off. On the other hand, if the originator is not the first one contacted by the borrower, the explanations may involve less time. Firms taking applications electronically may face using less personnel time taking applications and explaining loan product and up-front fee/interest rate options, but more personnel time developing good software. In either case, however, taking applications involves costs.

In addition, the costs of gathering information and limited underwriting will be incurred. Whether electronic or manual, this involves costs. So originators face application costs along with the information gathering and credit analysis costs for each applicant. To a certain extent, these information gathering and underwriting costs would have been incurred in any event. However, to the extent that borrowers seek multiple offers, beyond what they do in today's market, there will be addition information gathering and preliminary underwriting costs.

Each shopper will generate multiple applications and, of course, multiple application costs. Originators must cover these costs from the loans that are accepted by the borrowers. The cost of each closed loan, then, will reflect the cost of the average number of applications per closed loan for that originator. It is hoped that the increase in competition generated by shopping will more than offset the increase in costs imposed by multiple "free" applications.

A potential problem here is that good explanations of loan options and the interest rate/up-front fee trade-off may be more costly than doing a second rate job. If so, the originator's costs are higher which would tend to make him less competitive in the market. Only to the extent that the better explanations lead to higher success rates in closing loans or a willingness of the borrower to pay more for a loan will the originator profit. It seems reasonable to expect that good explanations, or good information, will lead to borrower loyalty and willingness to pay.

F. Effect on Private Mortgage Insurers

Private mortgage insurance (PMI) shields the lender from much of the default risk associated with a mortgage loan. It is required by Fannie Mae and Freddie Mac for loans with loan-to-value ratios over 80%. PMI is usually selected by the lender. This is in essence a firm-to-firm transaction with knowledgeable professionals on both sides. The number of lenders in the market is large while there are seven PMI companies who dominate the market. While there is the potential for a cartel to develop with this few firms dominating the market, a recent report on the PMI industry by Morgan Stanley concludes that PMIs are intensely competitive with one another.[79] Thus, the current environment appears already competitive and we would not expect major changes as a result of packaging.

V. Other Topics Related to Packaging

This section briefly discusses two additional issues related to packaging. Subsection A examines the effects of the safe harbor and subsection B discusses caps.

[79] Morgan Stanley, US Mortgage Finance, February 5, 2002, p. 66. This discusses the nature of the competition in the PMI industry.

A. Effects of the Safe Harbor

As noted in subsection II.A, HUD concluded that Section 8 prohibitions and questions about how they apply (particularly with respect to volume discount arrangements and average cost pricing) were holding back packaging. In its proposed rule, HUD has included a safe harbor to encourage packaging, in the form described in the above sections. There would be a safe harbor for the package fee and for any payments within the package from RESPA scrutiny. Originators would be shielded from suit about referral fees, kickbacks and unearned fees with respect to their package price and any fees within the package. Lenders who prefer to charge the average cost of a service to each borrower do not have to worry about situations where (say) a borrower who needed only the low cost credit report would have the same price as one with a high cost credit report. The safe harbor eliminates this as an issue.

This proposed rule already contains a statement that the Department does not believe that RESPA prohibits the originator from seeking out low prices for settlement services that would be used in the process of getting a loan provided that there was no mark-up by the originator of the price (see Chapter 3). Such activity is viewed as pro-consumer since it would be the originator, who is likely to be quite knowledgeable about settlement service markets, who shops for the service rather than the borrower, who is likely to be a relative novice. In addition, the originator is large relative to the single borrower and the large volume of business at stake might lead to even lower prices for borrowers. Absent competitive conditions, the originator could raise his origination fee by the amount of the discount and keep the combined price of the loan fees, interest rate dependent payment, and third party fees the same. At the other extreme, the originator would leave the origination fee as is and the borrower gets the full benefit of the discounts. In between, the benefit is split between the two. As competitive pressure among originators is greater, the pressure will be greater for more of the benefit to be passed on to the borrower.

The simplification under packaging yields only one number in terms of an upfront fee that the borrower can haggle over, the package price. The competitive pressure the borrower applies to that number is putting pressure on the originator to eliminate economic (above normal) profit. With simplification, it is expected that there will be more shopping. With everything packed into one number, the increased shopping puts pressure on originator economic profit from all sources to fall. It is expected that this will provide considerable pressure for third party discounts to be passed on to borrowers in the form of lower package prices.

In the sense that any pro-competitive behavior on the part of the borrower subjects all the components of the package to competitive pressure, overall competition may be enhanced by packaging with more price reductions going to borrowers.

B. Caps

In order for an originator to take advantage of the guaranteed packaging option, the proposed rule provides that the loan may not be a "high cost loan" as defined by the Home Ownership Equity and Protection Act. An interest rate test is one of the triggers for the high cost classification. If the APR exceeds the Treasury rate on comparable term bonds by 8% for first lien loans or 10% on second lien loans, then the loan is defined as high cost by HOEPA and the loan is ineligible for the guaranteed packaging approach. Another test is the up-front fee test: If upfront fees exceed 8% of the loan amount, the loan is again ineligible for packaging. The high cost exclusion here is designed to prevent relatively costly loans from gaining the safe harbor.

The cost of originating a loan depends on many factors. Some of these include the nature of borrower income, the credit history of the borrower, the number of borrowers, or whether the home is new construction or not, just to mention a few. So the reasonable cost of originating a loan varies. A cap designed to limit excess profit also has the effect of limiting originator fees that might be needed to cover the higher costs incurred in a more complex loan application. If costs cannot be covered under the cap, the loan will not be made under this program. Any cap must be set with this conflict in mind, the trade-off between limiting abuse on the one hand and limiting access to credit under this program on the other. Gramlich (2002) reports that the HOPEA cap covers about 26-38 percent of the subprime market;[80] thus, a significant portion of that market would not be eligible for packaging. Further increasing the cap thresholds would restrict even more loans from packaging. These loans would fall under the new GFE approach in the proposed rule.

Another potential problem is the use of a cap by some originators as a marketing tool. They may claim that their fees are "government approved" as a way to persuade the borrower that a fee is competitive or reasonable. In fact the cap may be above what is reasonable for many loans because of the trade-off mentioned earlier. If care is taken in describing the purpose of the cap to borrowers, the likelihood of borrowers being taken by the "government approved" argument will be reduced.

Another issue, under packaging, stems from the fact that yield spread premiums will not be separately reported by brokers as lender payments to borrowers for higher interest rates. Lenders, of course, never had to report these numbers. This means that while the cap limits up-front borrower payments, it does not limit what the lender or broker can receive from a premium rate, the yield spread premium. It must be remembered that yield spread premiums exist an all premium rate loans whether brokered or not, but are realized in the accounting sense only upon the sale of the loan. So the cap does not put a limit on originator compensation, only the competitive process does.

A question in the proposed rule seeks public comments on the cap issue.

[80] Gramlich notes that the 38 percent estimate is due to including single-premium credit life insurance in the definition of points and fees; if the lending industry stopped selling this insurance, the HOPEA coverage percentage would fall back toward 26 percent.

VI. Compliance and Other Costs[81]

GMPA. Sections VIII.A-C of Chapter 3 discussed several factors related to the impact of the proposed new GFE form on originator costs. These factors related to (1) the recording of yield spread premiums, (2) itemization of fees, (3) requirement for a new worksheet showing alternative interest rates, (4) the contents of Attachment A-1 (page 3), (5) redisclosure requirements, (6) the HUD-1, and (7) the cross walk between the new GFE and the HUD-1. For each of the seven factors discussed in Sections VIII.A-C of Chapter 3, the Guaranteed Mortgage Package Agreement (GMPA) form will either lead to smaller costs than the new GFE form or have the similar costs to those discussed for the new GFE form. The Guaranteed Mortgage Package Agreement presents fewer numbers and less detail than either the current GFE or the proposed consolidated GFE discussed in Chapter 3. While the originator still has to know all the costs associated with getting a loan in order to fill out the GMPA, only six numbers go on the GMPA – the package price, four other settlement costs (per deim interest, reserves/escrow, hazard insurance, and optional owner's title insurance), and total settlement costs. Instead of a long list of fees, there will be only this short list of fees. This will be more efficient in that no originator will have to go through any long explanation of what each itemized fee is for; there will be no itemization. Neither will there have to be any explanation of what any of the junk fees are. There are none. This will lead to a more efficient origination process since no time will be spent by the originator or borrower in deciphering the breakdown of the originator's fee into various components and junk fees. This needless breakdown may be avoided on the HUD-1 as well. The same kind of efficiencies may be attained with respect to title insurance and settlement agent fees.

Chapter 3 concluded that the net costs of the new GFE from the seven factors mentioned above could be zero or a small amount (such as 10 minutes). In the case of the GMPA, there appears to be no net cost and, in fact, there could be a net savings. For purposes of our calculations, it assumed that the GMPA is no more costly to handle than today's GFE. Chapter 3 also discussed one-time (first year) costs of switching to the new form and training employees on its use. The one-time costs for the GMPA would certainly be no more than those for the proposed new GFE, which were estimated (under specific sets of assumptions) to be $55-$95 million dollars; the reader is referred back to the discussion of one-time costs in Section VIII.C of Chapter 3.

Average Cost Pricing. Packaging eliminates the reporting of individual fees within the package and in so doing permits, in effect, average cost pricing. This reduces costs because firms do not have to keep up with an itemized, customized cost for each borrower. Industry sources have told HUD that this could be a significant cost savings under packaging.

However, any cost that goes into the finance charge, as defined for the Truth in Lending Act (TILA), must still be recorded correctly on the HUD-1; of course, originators do that today. But under packaging, those charges not included in the finance charge (for TILA purposes)

[81] While this section includes "costs" in the title, many of the changes in the GMPA under packaging lead to savings (or negative costs) due to increased simplification; still, for purposes of consistency, the discussion here follows the discussion of costs in Section VIII of Chapter 3 for the new GFE form.

would not have to be recorded separately on the HUD-1, a net savings relative to the current GFE as well as relative to the proposed new GFE.

If the savings mentioned above from average cost pricing were one-half percent of the originator's total fees (estimated to be $30 billion in aggregate), the dollar savings associated with average cost pricing would be $150 million. While other assumptions could be made, this assumption of one-half percent savings provides an order of magnitude estimate.

Interest Rate Guarantee. There could be some additional costs associated with lenders having to use an as yet undetermined index in order to guarantee market interest rates (a) during the time that the consumer is shopping (after the packager has made the offer); and (b) during the time between the offer being accepted and final closing for those borrowers who choose to "float" rather than "lock-in" their interest rate. There is no available interest rate series that has been accepted by the industry to serve as this index of how the market moves; the proposed rule seeks comments on how the interest rate index should be determined, as well as whether there are alternative mechanisms for achieving the interest rate guarantee.

Regardless of the approach chosen, there will likely be some additional costs. Interest rates on various credit instruments, even with the same term, are not perfectly correlated. Mismatches between the moves in the market in which the originator can sell the loan and the index used to adjust the offer to the borrower could put the originator at risk; if so, originators will charge for that risk. Of course, the mortgage industry is used to dealing with indexes; for twenty years, lenders have been using a variety of market indexes (Treasuries, cost of funds, LIBOR) to adjust interest rates on ARMs, which suggests any costs related to this index could be small. In addition, it is anticipated that most borrowers will follow standard practice and choose to lock-in, rather than to float.

The magnitude of the additional costs associated with the index issue is difficult to estimate and, in reality, can't be determined until a mechanism is specified. As noted above, the industry's familiarity with indexes and the fact that most borrowers choose to lock their rates after accepting an offer, suggest that this issue will not involve large costs. But, without more information about the nature of the likely indexes and the industry's comfort with them, it is difficult to estimate additional costs. For this reason, the proposed rule asks for industry comments on how an interest rate index could be determined, or if there are alternative mechanisms to ensure that borrowers receive market rates.

Free, Guaranteed Offer. As discussed in Section IV.E, packaging requires that originators make a free offer that is also guaranteed. Today, loan originators often spend time with prospective applicants without receiving any compensation. While there is no guarantee in today's environment, firms find it to their advantage to offer these services at no charge. In addition, any information gathering (e.g., credit history data) and underwriting done at any early stage are used in the full underwriting process, which means they do not involve additional costs – these costs would have been incurred in any event. However, as explained in Section IV.E, to the extent that borrowers seek multiple offers, beyond what they do in today's market, there will be additional information gathering and preliminary underwriting costs on the part of originators. On the other hand, there are currently 1.7 times as many applications as there are loans originated. Preliminary underwriting should decrease the number of applications that go to full underwriting. That is, in today's mortgage environment (year 2002 assumptions), full underwriting is started (and probably completed) for about 19 million applications, including 8 million (19 million minus 11 million originations) that are not originated. This saving would tend to offset the increase in cost resulting from the extra preliminary underwriting and the free, guaranteed offer noted in the above paragraph. However, it is difficult to estimate these effects.

There could develop some degree of uncertainty and costs associated with making guaranteed interest rate offers particularly for those borrowers who typically require extensive underwriting (such as someone who has a low credit score). As discussed in Chapter 3, if the borrower doesn't qualify for the loan presented in the originator's GMPA and a new loan is offered, a new GMPA must be filled out with the appropriate changes. But the borrower would be given these changes today for a new loan. The proposed rule simply requires that the new information be conveyed to the borrower through a new revised GMPA.

Arranging the Package of Third Party Settlement Services. This section concernsthe costs associated with the arrangements that packagers have to make with third party settlement service providers, in order for the packager to ensure that there would be no change in third party prices and that the packager could live up to its guarantee without taking a loss. This issue was discussed in Section VIII.F of Chapter 3 with respect to the zero tolerance requirement under the new GFE, and readers are referred to that discussion for the details. Packagers must gather reliable information about third-party-settlement-service providers and exert the effort to build a package that can be delivered at the guaranteed pricing rate. Work would be involved in formalizing an agreement to commit the third party to a fixed price. This requires the packager to do more than today, although even today originators fill out GFEs with estimates for third party settlement services. So originators today have to have a working knowledge of third party settlement service prices to fill out a GFE anyway. Therefore, it is only the increase in burden that would need to be accounted for here. Noting the difficulty of estimating these incremental costs, Chapter 3 provided cost estimates ($26-$52 million) associated with originators making necessary arrangements to ensure zero tolerance under the new GFE approach.

In some cases, packaging could be a little more complicated than the zero-tolerance requirement of the new GFE approach; for example, the packager has to do the complete package and can't leave anything to the borrower. But there are also reasons why packaging may be less costly relative to the new GFE approach. Packaging takes the borrower out of the payment stream as a complicating factor; the originator does not bear the responsibility of the borrower's dealing with the third party provider. A further simplication might result if specialized firms (called packagers) develop who simply arrange for third party settlement service providers. Under this structure, the originator deals with the packager (i.e., the specialist) and the packager deals with all the service providers. Thus, under packaging, there could be a substantial reduction in transactions (and exchange of information) between originators and service providers. Overall industry transaction costs could fall with the introduction of these specialists firms who handle third party settlement service providers. In addition, the third party specialist firms might be more efficient in arranging these settlement services than the individual loan originator, and certainly more efficient than borrowers. These latter two considerations suggest that the overall costs of arranging settlement service providers might be lower under packaging than under the new GFE approach and might even be lower than what it is today. This efficiency gain would be difficult to estimate, particularly since packaging could follow a number of structures.

VII. Summary of Benefits, Costs, Transfers, and Efficiencies

This pulls together much of the information about benefits, costs, transfers, and efficiency gains that have been discussed under the Guaranteed Mortgage Package Agreement (GMPA). Quantitative estimates are provided below. As discussed throughout this chapter, it is difficult to estimate these effects, given available data. The reader is referred to earlier sections for the specific assumptions behind these estimates.

Transfers: As noted in Section III. D, transfers from firms to borrowers would be $10.3 billion under guaranteed packaging ($4 billion more than under the new GFE). Originators contribute $6.7 billion of this and third party settlement service providers $3.6 billion. This benefit to consumers comes from further reductions in overcharges that competition passes on to borrowers. The small business share of the $10.3 billion would be $5.9 billion.

Efficiencies: While most of the effect of this guaranteed packaging comes in the form of transfers, many efficiencies have been discussed. They are listed below.

(1) Borrowers will save more time shopping for loans and third party settlement service providers. If the new GMPA forms save the average applicant an additional hour in shopping time over the new GFE, borrowers save $1.322 million. In addition, if borrowers save another 15 minutes in shopping for required third party services, above the saving from using the new GFE, they save a total of $330 million. The total value of borrower time saved shopping for a loan and third party services comes to $1.652 billion.

(2) Originators and third party settlement service providers will save more time as well. If half the borrower time saved comes from less time spent with originators and third party settlement service providers, then originators spend one hour less per loan originated talking to borrowers and third party settlement service providers spend 15 minutes less with borrowers for a total saving of $1.360 billion and $340 million respectively for a total of $1.7 billion.

(3) Lower prices for originators and third party settlement service providers drive out the less efficient firms with the more efficient firms surviving and doing the work. It is difficult to estimate this effect. But if the efficiency gains from loan originators from using the GMPA are two percent of origination fees, firms save a total of $600 million. This same effect would hold true for third party settlement service providers as well, resulting in a total savings of 360 million. The total effect from lower prices driving out the less efficient is $960 million.

(4) The lower profitability of seeking out vulnerable borrowers for abusive loans resulting from using the GMPA should lead to a reduction in this activity. If there is even a additional 2% drop in this lender effort compared to today, there would be $600 million in total savings to firms.

(5) It is estimated in Section VI that the benefits of average cost pricing (e.g., reduction in the number of fees whose reported values must be those specifically incurred in each transaction) will lead to a reduction in originator costs of 0.5 percent, or $150 million.

(6) There are other potential efficiencies that are anticipated from the new GFE approach, similar to those discussed in Chapter 3. Studies indicate that one impediment to low-income and minority homeownership may be uncertainty and fear about the home buying and lending process. Like the new GFE approach, packaging should reduce the fears and uncertainties of these families about the lending process.

The overall effect here is transfers of $10.3 billion to borrowers, with $6.7 billion coming from originators and $3.6 billion from third party settlement service providers.

In addition to the transfers, borrowers realize $1.652 billion savings in time spent shopping for loans and third party services. Loan originators save $2.710 billion in time spent with shoppers, efforts spent seeking out vulnerable borrowers, the substitution of more efficient for less efficient originators, less time spent filling out the GMPA, and simpler recordkeeping. Third party settlement service providers save $700 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. Some or all of the $2.710 billion and $700 million in efficiency gains have the potential to be passed through to borrowers through competition.

The simplification and other advantages of the new GMPA will lead to lower costs than under the new GFE. It is assumed that costs under the GMPA will be the same as today's GFE. As discussed in Section VI, one area of uncertainty about packaging and the new GMPA concerns the index that is used to ensure that changes in the interest (note) rate reflect changes in the market. Until the exact mechanism is selected, it is difficult to determine the effect of the index on packaging.

CHAPTER 5

SUMMARY OF THE RULE'S BENEFITS AND IMPACTS ON SMALL BUSINESSES

The proposed RESPA rule offers a dual approach to problems in the settlement market: a new, simplified GFE combined with tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions; and a guaranteed cost approach based on packaging of settlement services. This chapter provides a summary of benefits, costs, transfers, efficiencies, and market impacts of these two approaches, highlighting the effects on small businesses. Section I discusses the new GFE approach while Section II discusses the guaranteed cost approach, or packaging. The chapter also summarizes alternative approaches that HUD considered that potentially impacted small businesses. The format in this chapter is to list the major findings; additional details about the new GFE approach and packaging are available in Chapters 3 and 4, respectively.

I. New GFE Approach

The main benefits, costs, transfers, and market impacts of the new GFE approach are outlined below, along with the specific impacts on small businesses. Since most brokers and settlement service providers are small businesses, the main impacts of the new GFE approach on these entities are highlighted below in subsections I.C, I.D and I.F.

A. Shopping Benefits

The new GFE approach will improve consumer shopping for mortgages, which will result in better mortgage products at lower prices for consumers.

- The new GFE format in the proposed rule simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement over today's GFE, which contains a long list of individual charges that encourages fee proliferation and junk fees, and can often overwhelm and confuse consumers.

- The new GFE contains a statement that clarifies the role that the originator plays in the loan process. It states, for example, that the originator does not distribute the loan products of all funding sources, that the originator does not guarantee the best loan terms, and that the consumer should shop. This will put all borrowers on notice that they should protect their interests by shopping.

- The new GFE also makes cost estimates more certain, by requiring that loan originators adhere to amounts reported on the GFE for major cost categories (such as origination fees), and on additional cost categories give estimates subject to a 10% upper limit, or tolerance. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement.

- The new GFE will better inform consumers about their financing choices by requiring that lenders explain the different interest rate and closing cost options available to consumers. For example, consumers will fully understand the trade-offs between reducing their closing costs and increasing the interest rate on the mortgage.

- Altogether, the simplicity and certainty offered by the new GFE should improve comparison shopping for mortgage loans, reduce interest rates and settlement prices for borrowers, and eliminate surprises at settlement. There will be less of the sub-optimal consumer shopping that often characterizes today's mortgage market. In addition, originators will be less able to take advantage of uninformed shoppers.

B. Summary of Estimated Benefits, Costs, Transfers, and Efficiencies

Chapter 3 provided estimates of the magnitude of the benefits, costs, transfers, and efficiencies. Transfers totaled $6.3 billion to borrowers, with $4.5 billion coming from originators and $1.8 billion from third party settlement service providers. In addition to these transfers, there are efficiency gains: borrowers realize $826 million in efficiency gains from less time spend shopping; and loan originators and third party settlement service providers experience $1.630 billion in efficiency gains, some or all of which have the potential to be passed through to borrowers through competition. Costs to originators rise by approximately $250-$275 million. These estimates are explained further below. While they are based on specific assumptions (see Chapter 3), they provide a sense of the overall effects of the new GFE approach.

- Under one set of assumptions, Chapter 3 estimates that $7.5 billion of the $15 billion in total yield premium payments (YSPs) is not passed through to borrowers to reduce closing costs. If the proposed rule results in half of this $7.5 billion being recaptured by borrowers, then the annual impact would be $3.75 billion. While this figure will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on the return of YSPs to borrowers as reduced closing costs.

- Direct origination fees are estimated to be $15 billion (which when added to the $15 billion in YSPs results in total originator compensation of $30 billion). In addition to the $3.75 billion in YSPs recaptured by borrowers, it is also assumed that improved shopping enables borrowers to capture five percent (or $0.75 billion) of originators' direct origination fees of $15 billion.

- Chapter 3 estimates that $18 billion in third-party fees would be subject to increased price pressure as a result of the imposition of tolerances and expanded shopping by originators. While it is difficult to estimate how much tolerances and expanded originator shopping will reduce the $18 billion, this figure provides a base on which this effect will be felt. The estimates reported below assume that third-party fees would fall by 10 percent, or $1.8 billion.

- It was estimated that borrowers would save $6.3 billion in annual settlement charges.[82] This $6.3 billion represents transfers to borrowers from higher priced producers, with $4.5 billion coming from originators[83] and $1.8 billion from third party settlement service providers. While these figures will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on settlement charges to borrowers.

- In addition to the transfers, there are several efficiencies associated with the GFE. Borrowers realize $826 million savings in time spent shopping for loans and third party services. Loan originators save $1.280 billion in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save $350 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. Some or all of the $1.280 billion and $350 million in efficiency gains have the potential to be passed through to borrowers through competition.

- Costs to originators rise by $226 million if it takes 10 extra minutes to handle the forms and by $26 to $52 million to make third party arrangements in response to tolerances. (See “Costs and other Impacts” below.)

- As discussed throughout this chapter, the benefit, cost, transfer, and efficiency estimates are based on specific assumptions. The estimates provide a sense of the overall net benefits of the proposed new GFE approach to consumers. The rest of this summary highlights the main impacts of the new GFE approach.

C. New Treatment of Wholesale Lender Payments and Impacts on Brokers

An important feature of the new GFE approach is that it addresses the problem of lender payments to mortgage brokers.

- The proposed rule ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with an above-par interest rate, that is, yield spread premiums will go directly to the borrower. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through directly to borrowers as a

[82] As explained in Section IV.C of Chapter 3, the $6.3 billion represents about 13 percent of the baseline settlement costs, which include origination fees and selected third party costs (appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges). Survey, pest inspection, and mortgage insurance are not included, as they are not required on all loans. Thus, the $6.3 billion may be a conservative figure. This assumes, of course, that all the other assumptions underlying this scenario are correct.

[83] The $3.75 billion in YSPs recaptured by borrowers plus the $0.75 billion in reduced ' direct origination fees give $4.5 billion in transfers to borrowers from originators.

credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs.

- Similarly, the proposed rule ensures that in brokered transactions, consumers who choose to pay discount points receive the full market benefit in terms of lower mortgage interest rates.

- Under these new rules, brokers must report the total origination fees they receive on the GFE and the HUD-1 -- rather than their origination fees net of any yield spread premium they receive. Thus, the new GFE clarifies what brokers are receiving for loan origination.

- Most brokers are small businesses. The above changes in the method for reporting wholesale lender payments on the GFE and HUD-1 will reduce the incomes of those brokers who have been overcharging consumers by receiving a combination of origination fees and yield spread premium payments that is greater than that suggested by competitive markets. The new GFE will clearly indicate both (a) the broker's total origination fee received and (b) the net upfront origination fee to the borrower, after reduction for any yield spread premium that the wholesale lender pays the borrower. Consumers will have full information about broker fees, which will allow them to comparison shop and pay lower fees, compared with the situation they face in today's market.

- As explained in the proposed rule, it is not practical to implement such a system for lenders, which means that lenders can continue to report their origination fees on a net basis if they so choose.[84] However, HUD has designed the new GFE form so that it reduces any anti-competitive effects between brokers and lenders. For purposes of comparing lender and broker offers, the new GFE focuses the borrower's attention on the right number, which is the subtotal after reducing total origination fees by any lender payment to the borrower (i.e. yield spread premium). This should reduce any anti-competitive impacts of the proposed rule on small businesses.

- Furthermore, it is anticipated that market competition will increase the likelihood that yield spread premium payments will be passed through to borrowers throughout the market, in lender (i.e., non-broker) as well as broker transactions. The information that consumers gain from broker transactions concerning the money back on premium loans should make consumers act competitively with respect to premiums on similar loans from non-brokers.

- Brokers as a group will remain highly competitive actors in the mortgage market. Chapter II discusses the factors that will continue to keep brokers competitive with other lenders. As noted above, HUD has also designed the GFE to lessen any anti-competitive effects from the different reporting requirements of lenders and brokers on the new GFE. Therefore, there is no evidence to suggest that there would be any

[84] This also includes those brokers who have wholesale lines of credit.

major anti-competitive impact on the broker industry as a whole from the new GFE provisions in the proposed rule.

- Rather, the main impact on brokers (both small and large) of the proposed new treatment of payments by wholesale lenders would be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums. As noted above, it is anticipated that market competition, under this new GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high yield spread premiums and origination costs.

- As noted above, according to some estimates $7.5 billion in YSPs is not passed through to borrowers to reduce closing costs. While this figure will vary depending on specific assumptions, it provides a sense of how large the effects of the proposed rule could be on the return of YSPs to borrowers as reduced closing costs.

D. Lower Settlement Service Prices

In addition to reducing originator fees, the tighter tolerances of the new GFE approach would result in lower prices for third party settlement services. Settlement service providers who are small businesses would be impacted by any reduction in settlement service prices arising from the tighter tolerances on settlement fees.

- The imposition of tolerances on fees will encourage originators to seek discounts and cut settlement service prices. The proposed rule clarifies that loan originators can make arrangements with their third party settlement service providers (appraisers, settlement service agents, etc.) to lower prices for their customers (i.e., borrowers), provided these prices or any fees on the GFE are not "marked up" or "up charged."

- Section V of Chapter 3 examines the magnitude of third-party fees that would be subject to increased price pressure as a result of the imposition of tolerances and expanded shopping by the originator. As noted above, $18 billion in third party fees would fall into this category. While it is difficult to estimate how much tolerances and expanded originator shopping will reduce the $18 billion, this figure provides a base on which this effect will be felt. The estimates reported above under "Summary of Estimated Impacts" assumed that third-party revenues would fall by $1.8 billion, or 10 percent.

- It is estimated that small settlement service providers would account for $1.3 billion of the $1.8 billion decline in third party revenues. But as discussed in Chapter 3, this estimate is subject to variation.

E. Costs and Other Impacts

Chapter 3 identifies several factors might impact the costs of handling the new GFE form. As noted below, many of these factors tend to offset each other with end result being that annual additional costs appear to be small.

- There are some direct costs to originators from complying with the GFE portion of the proposed rule. These do not appear to be very large. While the new GFE format requires less itemization than today's GFE, the HUD-1, with its detailed itemization, remains essentially the same. Originators and closing agents will have to expend some minimal effort in explaining to consumers the cross walk between the new streamlined GFE and the more detailed HUD-1. There is a new page of the GFE showing interest rate alternatives, which should not impose much additional costs, given that most originators do that in some form today. Annual costs to originators rise by $226 million if it takes 10 extra minutes to handle the new GFE form. Chapter 3 also estimates that first-year startup costs could range from $55-$95 million.

- There will be some costs to originators from the need for additional preliminary underwriting in order to generate new GFEs. While this underwriting is already occurring for full applications today, it is expected that some borrowers under the new GFE will get multiple applications and use them to shop. However, it is difficult to estimate how many additional GFEs and preliminary underwritings will result under the new GFE scheme. In addition, as discussed in Chapter 3, the number of applicants going to full underwriting could decline under the proposed rule.

- The imposition of zero and 10 percent tolerances on fees will require lenders to take some actions that will increase their costs. For example, arrangements will have to be made with third party settlement service providers, in order for the originator to come up with estimates that can be delivered within the 10 percent tolerance. As noted above, these are estimated to range from $26 to $52 million.

F. Small Business Impacts – A Summary and Alternatives Considered

Chapter 3 estimates that $3.5 billion of the $6.3 billion in transfers would come from small businesses. The above summary bullets highlight the mechanisms in which this will happen. Improved consumer shopping among originators and more aggressive competition by originators for settlement services will lead to price reductions. Originators (both small and large) and settlement service providers (both small and large) that have been charging high prices will experience reductions in their revenues. Of the $3.5 billion impact on small businesses, it is estimated the $2.2 billion will come from small originators and $1.3 billion, from small settlement service providers.

Market impacts on different types of businesses are discussed throughout Chapter 3, as well as in the summary bullets under C and D above. Chapter 3 also discussed alternative policies that HUD considered when developing the rule. Examples of alternatives that would impact small businesses include:

- One alternative considered was to place the interest rate dependent payment at the bottom of the form rather than directly after the origination charge. This was rejected since an unsophisticated borrower might misinterpret the broker's higher origination charge (relative to a lender who can net the yield spread premium out of the origination charge rather than list it separately as a lender payment to the borrower) as indicating that the broker's loan is more costly.

- The Department considered placing the division of the origination charge into broker and lender portions on the front page of the GFE but rejected that idea since the information was not useful in bottom line comparison shopping. Loans with identical origination charges will now have the same numbers presented in the origination charge whether originated by a broker or lender.

- The Department considered having zero tolerance on both the lender and broker components of the origination charge instead of zero tolerance on the total. Zero tolerance on the components would have given brokers less flexibility in switching lenders, even if the total of the lender and broker fees would remain the same. The method selected makes it easier for brokers to switch lenders, so long as the total origination charge does not rise.

- The Department considered having different statements of the services of the originator. The purpose of this section of the GFE is to alert borrowers to shop in order to protect their interests. Different statements could favor brokers over lenders, or vice versa. The Department adopted the idea that every originator would have to deliver the same message, so that every borrower gets the same warning and no originator is at a disadvantage in delivering the message.

II. Guaranteed Cost Packaging or Packaging

The main benefits, costs, transfers, and market impacts of the guaranteed cost or packaging are outlined below, along with the specific impacts on small businesses. Since most brokers and settlement service providers are small businesses, the main impacts of packaging on these entities are highlighted below in subsection II.F.

A. Overview of Packaging Benefits

First, guaranteed packaging will improve and increase borrower shopping for mortgages. Basically, guaranteed packaging reduces the loan offer to:a settlement package price, an interest rate, an APR, and a PMI premium rate. The package price and the PMI premium has zero tolerance, and the interest rate is guaranteed if locked (otherwise the rate varies with a market index). In addition, the offer is free and, if agreed upon by the borrower, the offer becomes a contract that is enforceable. These are all advantages over today's process of shopping for mortgages. Economic efficiencies result from easier and less time consuming shopping under packaging. Borrowers are better informed, shop better, and reach better deals.

Second, the guaranteed packing approach would remove regulatory barriers that are today preventing market competition from reducing settlement prices. Under current law, a providers' efforts to enter into volume arrangements with settlement service firms may be regarded as illegal and restrictions against mark-ups of third party costs may impede the packaging of services. Under HUD's proposed rule, packagers will be able to enter into cost-reducing, volume-discount arrangements, and competition among packagers will pass these lower costs through to borrowers at mortgage settlement.

B. Summary of Estimated Benefits, Costs, Transfers, and Efficiencies

Chapter 4 presents estimates of the magnitude of the benefits, costs, transfers, and efficiencies associated with packaging. Transfers total $10.3 billion to borrowers, with $6.7 billion coming from originators and $3.6 billion from third party settlement service providers. In addition to these transfers, there are efficiency gains: borrowers realize $1.652 billion in efficiencies from less time spent shopping and loan originators and third party settlement service providers realize $3.410 in efficiency gains, some or all of which have the potential to be passed through to borrowers through competition. These estimates are explained further below. While they are based on specific assumptions (see Chapter 4), they provide a sense of the overall effects of packaging.

While these benefits of packaging are basically similar to the benefits of the new Good Faith Estimate approach discussed in Section I, it is anticipated that packaging will improve shopping and lower settlement costs to an even greater extent than the GFE approach. Above, it was estimated that borrowers could save $6.3 billion in annual settlement costs under the new GFE approach. It is anticipated that a system based on packaging alone would lead to even greater savings for borrowers, as transfers from firms to borrowers will rise by $4 billion for a total of $10.3 billion. Originators contribute $6.7 billion of this and third party settlement service providers, $3.6 billion. This benefit to consumers comes from further reductions in overcharges that competition passes on to borrowers. Under this scenario, the final savings to the borrower would depend on how the market settles down between the two methods of loan origination – the new GFE approach and packaging. If it is half and half, borrower gains are slightly over $8 billion.

In addition to the transfers, there are several efficiencies associated with packaging (see the summary in Section VII in Chapter 4). Borrowers realize $1.652 billion savings in time spent shopping for loans and third party services. Loan originators save $2.710 billion in time spent with shoppers, in efforts spent seeking out vulnerable borrowers, and from the substitution of more efficient for less efficient originators. Third party settlement service providers save $700 million in time spent with shoppers and from the substitution of more efficient for less efficient third party settlement service providers. Some or all of the $2.710 billion and $700 million in efficiency gains have the potential to be passed through to borrowers through competition.

The simplification and other advantages of the new GMPA will lead to lower costs than under the new GFE. It is assumed that costs under the GMPA will be the same as today's GFE. As discussed in Chapter 4, one area of uncertainty about packaging and the new GMPA concerns the index that is used to ensure that changes in the interest (note) rate reflect changes in the market. Until the exact mechanism is selected, it is difficult to determine the effect of the index on packaging.

Concerns have been expressed about the impacts of the packaging approach on small lenders and small service providers. Chapter 4 estimated that small businesses (i.e., small originators and small service providers) would account for $5.9 billion of the $10.3 billion in transfers. The effects on small businesses are discussed below in II.F.

C. Shopping Benefits

Packaging offers numerous shopping advantages for consumers, compared to today's process of shopping for mortgages. Under packaing, borrowers are better informed and better able to comparison shop.

- Guaranteed packaging will improve and increase borrower shopping for mortgages. Basically, guaranteed packaging reduces the loan offer to two numbers (a settlement package price and an interest rate), has zero tolerance on the package price, and guarantees the interest rate if locked (otherwise the rate varies with a market index). In addition, the offer is free and, if agreed upon by the borrower, the offer becomes a contract that is enforceable. These are all advantages over today's process of shopping for mortgages, as well as over the Good Faith Estimate approach outlined in Chapter 3.

- The simplified loan offer under packaging does away with the proliferation of fees, including junk fees that often characterizes today's mortgage offers.

- The packaging agreement eliminates the separate reporting of the premium or discount associated with brokered loans. This is done to facilitate competition and comparison shopping.

- Economic efficiencies result from easier and less time consuming shopping under packaging. Borrowers are better informed, shop better, and reach better deals.

- In this case, the main transfers will be from originators who are charging above market prices to borrowers who are more informed and better able to comparison shop (see the $6.7 billion estimate reported above).

D. Lower Settlement Service Prices

The packaging approach will result in even lower prices for third party settlement services than estimated above for the new GFE approach.

- The Section 8 safe harbor will allow greatest protection to entities within the package from charges of illegal referral fees, kickbacks, and unearned fees. This will free up packagers to pursue lower prices for third party services in their package without concern that the technique used could be a Section 8 violation. Competition is substituted for regulation.

- Thus, packaging will result in lower prices paid for settlement services, as packagers aggressively seek discounts in third-party service prices. A better shopper (the packager) is substituted for the borrower as the searcher for third party settlement services.

- In addition, there are several efficiencies associated with packaging that could lead to lower costs. Under packaging, originators may deal with one packager, rather than a whole array of third party providers and the packager, who specializes in this activity, may be more efficient than the originator.

- Given the likelihood that there will be competition among a number of packagers, the lower third party service prices will be passed through to borrowers as lower costs for closing a loan. In this case, the main transfers will be from settlement service providers to borrowers (see the $3.6 billion estimate reported above).

E. Impact on Business Operations and Market Structure

The proposed RESPA rule offers a dual approach to settlement market problems – (1) a new, simplified GFE combining tolerances on final settlement costs and a new method for reporting wholesale lender payments; and (2) a guaranteed cost approach based on packaging. Consumers and originators can use either approach, which has the advantage of allowing the market determine the best approach under a given set of circumstances. While there are reasons to expect originators to move toward the packaging approach, it is difficult to estimate the share of the market that will ultimately fall under packaging, as well as the timing of the move toward packaging.

- An uncertainty with respect to the implementation of packaging concerns the interest rate index that determines changes in mortgage rates for borrowers who are shopping (before they sign the guaranteed packaging offer) and for borrowers who choose to "float" rather than "lock-in" their interest rate (at the time they sign the offer). Packaging depends on lenders finding an acceptable interest rate index, or some other mechanism for ensuring that any changes in the interest rate reflect overall market changes. As noted below, there will likely be some costs associated with lenders' guaranteeing that interest rates move only with market conditions, depending on the indexing technique chosen.

- As explained in this chapter, packaging could take several forms – for example, originators could develop their own packages or specialized firms could develop packages, or components of packages, which they would then sell them to originators.

The section on small business below highlights several additional market impacts of packaging.

F. Compliance and Other Costs

The simplification and other advantages of the new Guaranteed Mortgage Packaging Agreement (GMPA) will lead to lower costs than under the new GFE.

- The GMPA and HUD-1 with packaging will have substantially fewer numbers and less detail than the current GFE and HUD-1. Only six numbers are required on the first page of the Guaranteed Mortgage Packaging Agreement. This will lead to a more efficient origination process since less time will be spent by the originator and the borrower in deciphering the proliferation of fees that now characterizes the GFE and HUD-1.

- Packaging eliminates the reporting of individual fees within the package and in so doing permits, in effect, average cost pricing. This reduces costs because firms do not have to keep up with an itemized, customized cost for each borrower.

- As mentioned above, there could be some additional costs associated with lenders having to use an as yet undetermined index in order to guarantee market interest rates (a) during the time that the consumer is shopping (after the packager has made the offer) and (b) during the time between the offer being accepted and final closing for those borrowers who choose to "float" rather than "lock-in" their interest rate. The proposed rule asks for comments on how the interest rate index could be determined.

- Originators make a free offer that is also guaranteed. This will require additional information gathering and preliminary underwriting to the extent that borrowers seek multiple offers, beyond what they do in today's market. There could also develop some degree of uncertainty and costs associated with originator's making guaranteed offers based on preliminary underwriting, particularly for those borrowers who typically require extensive underwriting. As explained in Chapter 4, however, this would simply result in the originator making a new loan offer or sending their customer elsewhere.

- There will be some costs associated with the arrangements that packagers have to make with third party settlement service providers, in order for the packager to ensure that there would be no change in the pre-arranged third party prices. But as discussed in Chapter 4, other efficiencies resulting from packagers dealing with third party providers are expected to offset these costs.

G. Summary of Small Business Impacts and Alternatives Considered

As noted above, concern has been expressed about the market impacts of packaging, particularly as they relate to small businesses. The main findings regarding the effects of packaging on small businesses are as follows:

- The nature of locally-provided, third party services (such as appraisal, survey, pest inspection, closing agents) could remain the same under packaging – the main change will involve who purchases these services. Packagers will be the new purchasers of these services, and third party service prices will be lower.

- Under packaging, those third party service providers (both large and small) who are currently charging high prices for their settlement services would experience reductions in the prices of their services. To the extent that third party settlement service providers happen to be small businesses, they would, of course, experience a reduction in their revenues. Of the $3.6 billion in price reductions for third party services, the small business share is $2.5 billion.

- It is estimated that small businesses (i.e., small originators and small service providers) would account for $5.9 billion of the $10.3 billion in transfers to consumers noted above -- $3.4 billion of this would come from small originators and $2.5 billion would come from small settlement service providers. As in the case with the new GFE approach, firms suffering losers under packaging are originators and third party providers who are currently charging high prices for their services.

- Still, there is no strong reason to expect that locally-based small businesses could not continue providing third party settlement services under packaging, albeit at possibly lower prices and revenues, as noted above. Services that are local in nature (such as appraisals) will continue to be demanded under the packaging approach. Services that are national in nature and characterized by economies of scale (such as credit reporting) are already being conducted by larger firms on a national scale.

- There has also been a concern that small lenders would be placed at a disadvantage under packaging because of the "bulk" buying power of large lenders. While this may be the case, it does not have to be. First, there is no evidence of this effect today where large lenders can purchase services such as appraisals on a "bulk" basis. Second, if specialized packaging firms develop, it seems reasonable to expect them to offer their packages to small lenders as well as large lenders. It is difficult to reach firm conclusions about the magnitude of the impact on small lenders.

- Brokers, most of whom are small businesses, could pursue a number of avenues under packaging. They could develop their own package, purchase one from specialized firms, or use the package offered by the wholesale lender they are dealing with. Under packaging, brokers will continue their main function of reaching the consumer, just as they do today. This customer outreach function is not going to go away with packaging.

- Furthermore, Chapter 2 of this Economic Analysis reports that technology improvements and other recent changes in the mortgage market have probably increased the competitive position of brokers relative to other originators. These underlying strengths of brokers are also not going to disappear with packaging.

Chapter 4 discusses alternative policies that were considered with respect to packaging. The Department considered writing this proposed rule as if only lenders could package. This idea was rejected in favor of allowing anyone to package so long as the package contains a loan. This further affords smaller firms the opportunity to offer their services and benefit from a packaging environment.

Under packaging, there is no separate treatment of yield spread premiums or discounts and no special rules for brokers. Thus, all originators present their loans the same way and all the market's competitive forces are applied to everything in the package regardless of the type of originator. No broker, or any other kind of originator for that matter, is at a competitive disadvantage.

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